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INCOME TAX TREATIES

HEARING

BEFORE THE

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OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

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INCOME TAX TREATIES

TUESDAY, APRIL 29, 1980

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, D.C.

The subcommittee met at 9 a.m., pursuant to notice, in room 2257, Rayburn House Office Building, Hon. Sam Gibbons (chairman of the subcommittee) presiding.

[Press release announcing the hearing follows:]

[Press release of Apr. 23, 1980]

Ways and Means Oversight to Hold Hearing on Tax Treaties

Chairman Sam M. Gibbons (D-Fla.) today announced hearings to be held on Tuesday, April 29, 1980 by the Oversight Subcommittee in order to explore the nature and implications of income tax treaties to which the U.S. is a party. Chairman Gibbons stated, "Last year the Oversight Subcommittee began looking into the use and abuse of offshore tax havens. As a result we learned that income tax treaties are a significant adjunct to the basic U.S. tax system and impact upon this system substantially."

Currently, the U.S. has 28 bilateral income tax treaties in effect. In addition, the treaties with the Netherlands, Belgium, and the United Kingdom have been extended to 19 present and former territories of those three countries so that the U.S. actually has income tax treaties with 47 different foreign countries or territories.

Chairman Gibbons further observed, "Even though tax treaties override or modify certain provisions of the Internal Revenue Code, the tax-writing committees of Congress are not involved in ratifying them or even formulating the underlying policy for these international agreements." The hearing will attempt to uncover what the tax treaty policy of the United States is, what it should be for various categories of countries, and how and to what extent the tax-writing committees should be involved in making that policy. The hearing will also examine how treaty shopping abuse can be eliminated.

Witnesses will include David Rosenbloom, International Tax Counsel of the Treasury Department; David Brockway, International Tax Counsel of the Joint Tax Committee staff; Professor Hugh Ault of the Boston College School of Law; David Tillinghast, Marshall Langer, Carl Nordberg, all private tax practitioners; Barry Spitz, an international tax advisor; and Robert Patrick, Senior Tax Counsel of the Exxon Corporation. A hearing room will be announced shortly.

Mr. Gibbons. This is a meeting of the Oversight Subcommittee of the Ways and Means Committee.

Today the Oversight Subcommittee again delves into those complex provisions of the tax law that are concerned with international transactions. Last year this subcommittee explored the nature and implications of offshore tax havens in hearings held on April 24 and 25, 1979.

In addition, the subcommittee and its staff have reviewed and monitored developments relating to the foreign tax credit, the tax treatment of foreign investors in the United States, the foreign bank account question, foreign corporate bribes and slush funds and the disclosure of tax return information affecting investigations of international transactions. The staff has also monitored GAO's study of intercompany pricing and the IRS administration of section 482, undertaken at the subcommittee's request.

These activities, especially the subcommittee's tax havens hearings, have clearly indicated the importance of U.S. income tax treaties in the U.S. tax system.

First: Income tax treaties are important because some parts of them modify or override certain provisions of the Internal Revenue Code.

Second: Tax treaties establish a mechanism for the exchange of information between tax administrators of treaty countries.

Third: Tax treaties, because their primary goal is the elimination of double taxation, create the ability for the legal reduction or elimination of tax on global transactions.

Fourth: The U.S. tax treaty network is often abused by third-country residents to avoid either United States or the third-country's tax, commonly referred to as "treaty shopping" abuse.

Despite the importance of treaties to the tax system, the taxwriting committees are not involved in formulating the underlying tax treaty policy of the United States. Since income tax treaties are just that, treaties, they are negotiated primarily by the Office of International Tax Affairs of Treasury and ratified by the Senate with jurisdiction lodged in the Senate Foreign Relations Committee.

The subcommittee's hearing today will explore the ways by which tax treaties modify or override certain provisions of the Internal Revenue Code. Further, the hearing will examine what the U.S. tax treaty policy is, as well as what it should be. Other issues that will be considered include:

What are the tax and other objectives of tax treaties and are they appropriate objectives?

What are the tax and other principles embodied in the U.S. Model Income Tax Treaty, the starting point for U.S. negotiators?

What guides U.S. negotiators when those principles are conceded during treaty negotiations?

Should an effort be made to somehow coordinate tax treaties with the Internal Revenue Code?

Why should the United States have tax treaties with tax haven countries? What can be done to prevent the abuse of such tax treaties?

How and to what extent should the taxwriting committees be involved in formulating the underlying tax treaty policy of the United States?

This morning we will hear from a number of distinguished witnesses. Our first witness, David Brockway, International Tax Counsel of the Joint Committee on Taxation staff, will discuss the significance of tax treaties in the U.S. tax system. Because of the shortness of time we have today, I have asked all witnesses to summarize their statements.

STATEMENT OF DAVID H. BROCKWAY, INTERNATIONAL TAX COUNSEL, JOINT COMMITTEE ON TAXATION STAFF, ACCOMPANIED BY HOWARD M. WEINMAN, LEGISLATIVE ATTORNEY, AND THOMAS B. JOYCE, ACCOUNTANT

Mr. Brockway. Thank you, Mr. Chairman.

I am happy to be here this morning. I am accompanied by Howie Weinman and Tom Joyce who also work on international tax matters with me. In my presentation I have been asked by the committee to give a general overview of the impact which the treaties have on the code and to summarize the negotiation and ratification process.

The following witnesses will discuss in depth the issues raised by our tax treaty program, but I will be happy to answer any questions of the committee on that. We have prepared a rather detailed statement discussing the matters the committee has asked us to testify on. I will not attempt to go over that statement directly.

The United States presently has 28 income tax treaties which, because of extensions to former colonies and territories, cover almost 50 foreign countries or territories.

At the moment, there are four treaties which have been submitted to the Senate but which have not yet been acted on. There is a proposed treaty with the Philippines and a proposed treaty with Morocco which were sent up a couple of years ago that have certain problems with them which are yet to be resolved. Then there are treaties with Malta and Cyprus which have just been sent to the Senate.

Also Treasury has active negotiations ongoing with about 10 countries. In a number of those cases they are new tax treaties and in a number of other situations they are revising existing tax treaties to try to modernize them, to bring them into line with our present treaty policy.

We also have 13 estate tax treaties. Three of those estate tax treaties also cover gift taxes.

Finally, in an area that is somewhat analogous, in 1977 legislation provided for social security totalization agreements which are international agreements affecting social security taxes. They are, however, negotiated and approved in a much different procedure than the income tax treaties.

The income tax treaties basically have two purposes. The first is the avoidance of international double taxation—that is, taxation of the some income by both the United States and a foreign government. The other purpose of the treaty is prevention of tax evasion.

Since the United States has unilateral rules in the code for dealing with double taxation, the treaties by and large complement what we have in the code.

The code structure is to tax U.S. taxpayers on a worldwide basis and give a foreign tax credit against their income tax on their foreign source income. For foreign taxpayers, we generally tax them on their U.S. source income. The treaties modify those rules to a certain extent because there are many cases where our code rules do not exactly match with foreign rules, and the treaties attempt to resolve those double taxation cases which are not dealt with under the unilateral Code rule.

As a general rule, the treaties do not modify U.S. tax laws as they affect U.S. taxpayers; they modify U.S. taxation of residents of the foreign treaty partner. The treaties reduce our taxation on their income on the assumption that it is being taxed by the foreign government. The U.S. taxpayer is affected largely by treaties in that the foreign government gives reciprocal reductions and exemptions to U.S. taxpayers. In fact, this structure is set out in what is called the saving clause in the treaty, where we say that, by and large, the treaty provisions do not affect U.S. taxation of U.S. taxpayers.

The principal exception to this is the foreign tax credit articles of the treaty, which do affect U.S. taxpayers. We agree in all our treaties except the treaty with the Soviet Union to grant foreign tax credit for income taxes imposed by the other government on the income from sources within that country.

The reason, in large part, I think, for the rule that the U.S. tax treaties do not affect taxation of U.S. persons is that that is a situation where the taxpayer is in the personal jurisdiction of the United States, his worldwide net income can be determined without great difficulty, and double taxation ordinarily can be resolved by the United States through legislation. Ordinarily there is no need to modify our rules in agreements with the foreign country to make sure we relieve double taxation affecting U.S. persons.

The relationship between the code and treaties is that the treaties are on an equal footing under the Constitution with the code. They have the same effect as Federal statutes. Where there is a conflict between a statute and a treaty, where the conflict is clear, then the one later in time, either the treaty or the legislation, will prevail.

In the treaties themselves there are a number of provisions that govern the relationship with the code. The first is the savings clause. which, as I mentioned previously, provides that, for U.S. taxpayers, the treaties generally don't affect the code rules.

There is another rule contained in almost all treaties that says, in effect, that the treaty benefits are elective in nature. A taxpayer can obtain the benefit of the treaty provisions that reduce taxation but is not required to accept the rules of the treaty which, if they are different from the code rules, would tend to increase his taxes.

Some questions arise where there are several provisions changed by a treaty, some of which may be adverse to taxpayers, some of which may be beneficial to the taxpayers. They deal with the subjective line as to how much of a treaty a taxpayer has to accept in order to take a treaty benefit. For example, if he accepts an exemption from foreign tax under the treaty and the treaty also says that that income is to be U.S. source, whether the taxpayer is required, in claiming the exemption of that type of income under the treaty, also to treat it as U.S. source even though the code would treat that particular item of income as foreign source. There are a number of questions as to exactly what situations you have to take adverse rules under the treaty if you are claiming a benefit under it.

In the code there are two provisions which set out the relationship between the code and the treaties. Neither of them was designed as an overall rule to govern the relationship. One section, section 894, was put into the code in 1936, at the time of our first treaty. Basically, it

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says that when a treaty would exempt income from U.S. tax, then that exemption will apply for purposes of the code even though the code might be amended in future years to tax that income. As long as the treaty provision exempts the income, even though subsequent legislation in future years treats that as U.S. taxable income, the treaty will prevail.

The other provision, section 7852(d), is a provision adopted in connection with the enactment of the 1954 code, and it provides that any treaty obligation in effect at the time of adoption of the 1954 code will prevail, notwithstanding subsequent amendments to the code. That really applies in only a limited number of circumstances, the latter provision, because we have only a few treaties left over predating the 1954 code; but to the extent they do, any subsequent amendments to the code are governed by that. Other than those two provisions, we don't have a comprehensive rule in the code for coordinating the code and the treaties.

There have been a couple of statutes passed since the treaty program began where the Congress has decided either to override existing treaties when it modified code provisions, as it did in the 1962 act, or to expand existing treaty benefits, as it did in the 1966 act. There are other situations where Congress expressly decided not to override the treaties even though the legislation would conflict with certain of them. Also, the current proposal to tax foreign investors in U.S. real estate, as reported out by the Senate Finance Committee, would conflict with existing treaty obligations and there are rules in the bill governing the resoluton of the conflicts. Basically, in that legislation there is a 5-year delay of the legislation to give Treasury time to renegotiate. Thereafter the legislation would prevail.

As you indicated in your opening statement, tax treaties, like other treaties, are initiated and negotiated by the executive branch. There is no involvement of the Congress in the negotiation process. The principal difference between tax treaties and other treaties is that they are negotiated by the Treasury Department rather than the State Department.

During the negotiation process, there is opportunity provided by the Treasury for public comment. Treasury has begun the process in recent years of announcing when it is starting negotiations with a country to give taxpayers an opportunity to make their views known on what they think would be important to include in the treaty. Also, Treasury has begun the process of having a public session after negotiations have begun to outline what is under negotiation with a foreign government and to receive comments from outside taxpayers as to their views on the contemplated provisions of the treaty.

After the treaty is signed, it is transmitted to the Senate for approval. As you indicated, the jurisdiction over the treaty is in the Senate Foreign Relations Committee and then it must be approved by two-thirds vote in the Senate.

Unlike certain other types of U.S. treaties, U.S. tax treaties are self-executing. They have been traditionally handled that way. They don't require legislation for them to have force of law.

To say that the taxwriting committees are not involved in the negotiation and ratification process is not to say that taxwriting committees don't have a role in the tax treaty program. For one thing, the taxwriting committees have had jurisdiction over the provisions of the code which set forth that the treaties are to prevail over the code provisions and under what circumstances. If there were other legislation along those lines, I would assume that legislation would also be in the taxwriting committees' jurisdiction.

I am not really in a position to comment parliamentarily on where the jurisdiction would lie, but if there were jurisdiction relating to treaty shopping—which will be discussed today—I would assume that legislation also would be a matter that is in the taxwriting committees' jurisdiction.

As indicated earlier, the taxwriting committees do have jurisdiction over legislation that modifies our tax laws and which can override tax treaties. That being the case, if the taxwriting committees disagree with what is in our tax treaties, the tax treaties can be looked at again by the tax committees in the consideration of overriding legislation. I would also assume that, because of that power, indications of what taxwriting committees felt were the appropriate areas to be covered by tax treaties would be important guidance for the Treasury Department.

I would think also that the taxwriting committees would have jurisdiction—I am sure they would have jurisdiction—over amendments to the code that would attempt to coordinate the tax treaties with the code rules. At the moment, I don't think there is a great deal of coordination. The code rules basically operate under different concepts than the international concepts reflected in the tax treaties, and the coordination of the two systems would be an area that would also be in the jurisdiction of the taxwriting committees.

I guess my final point here is that I would assume that when Congress consider legislation, the taxwriting committees consider legislation, they could make clear the extent to which the legislation should be subject to modification by treaties and what the consequences of those modifications would be.

I would assume the committees can do that. An example that comes to mind is the current legislation under consideration dealing with taxation of foreign investors in U.S. real estate. We are to come before the committee with recommendations in that area, and one possibility that we will be discussing with committee members is whether to recommend provisions indicating to what extent that we would give up the taxation of foreign investors if the foreign government were to tax that same income, to what extent we would allow the treaties to modify that legislation. That is another possible area.

That concludes my statement, and I will be happy to answer any questions of the committee.

[The prepared statement follows:]

Statement of David H. Brockway, International Tax Counsel, Accompanied by Howard M. Weinman, Legislation Attorney, and Thomas B. Joyce, Accountant, Joint Committee on Taxation

It is a pleasure to appear before you to discuss the ways in which U.S. tax treaties modify provisions of the Internal Revenue Code of 1954 and to describe the treaty negotiation and ratification process.

The United States currently has 28 income tax treaties in force. Because some of these treaties have been extended to present or former territories of treaty partners, these treaties apply to almost 50 foreign countries and territories. The U.S. tax treaty program dates to the first treaty between the United States and France, which became effective in 1936.

U.S. tax treaties are part of a worldwide network of tax treaties which many countries, particularly developed countries, have with one another. Many of these treaties are based in large measure on the common reference point provided by the model treaties developed by the Organization for Economic Cooperation and Development (OECD). The United States is a member of the OECD, and the model income tax treaty used by the Treasury Department as a starting point in negotiations draws heavily on the most recent OECD model. (However, the OECD model is not binding on the United States or the other OECD participants.)

Purposes of tax treaties.—Tax treaties to which the United States is a party serve two primary purposes: the avoidance of double taxation on the one hand, and the prevention of tax evasion on the other. Although U.S. tax treaties contain many differences in their details, they share certain fundamental approaches to the fulfillment of these purposes.

Double taxation of business income is generally avoided, and the administrative burden on international commerce is reduced, by providing that the income which a resident of one treaty partner earns from sources in the other treaty country cannot be taxed by the source country unless the taxpayer has a "permanent establishment" (usually a branch or office) there. Thus, more than minimal contacts with the source country are required before that country is permitted to impose its tax.

In the case of investment income (e.g., interest and dividends), many countries impose a withholding tax at a flat rate on the gross amount paid to a foreign investor for simplicity in the application and enforcement of the tax. (The United States imposes these taxes at a 30-percent rate.) U.S. tax treaties often avoid double taxation of this income by providing for reciprocal reductions in the rates of (or exemptions from) these withholding taxes.

An additional mechanism through which treaties may provide for the avoidance of double taxation is to provide that the country of the taxpayer's residence will allow some form of credit against its tax for the income taxes which the taxpayer must pay to the other treaty country. Recent U.S. treaties usually provide expressly that certain of the treaty partner's taxes are creditable, but allow the United States flexibility in determining the limits within which a credit will be allowed. Questions have been raised as to whether certain older U.S. tax treaties, which are differently worded, also grant a credit independently of the Code.

If the foregoing methods for alleviating double taxation fail to do so because the tax authorities of the two treaty partners take inconsistent positions on the treaty's application, the treaties provide that the taxpayer may ask the tax authorities of his country to attempt to reach an agreement with the authorities of the other country to resolve the difficulties.

To prevent tax evasion, the treaties authorize the tax authorities of each treaty partner to obtain information relevant to the liability of its taxpayers from the other treaty partner. Treaties also generally provide for assistance in collection by the treaty partners.

Negotiation and ratification.—The process by which tax treaties are negotiated and ratified closely resembles that which applies to other treaties, except that the Treasury Department, rather than the State Department, plays the major role in the Executive branch. A negotiated treaty is transmitted by the President to the Senate for its advice and consent and is there referred to the Foreign Relations Committee. Reservations to the treaty may be adopted by the Senate, and final passage requires a two-thirds vote. The treaty must also be ratified by the other country involved before the treaty may go into effect. The Ways and Means Committee and the Senate Finance Committee have no role in the ratification process, but they do have jurisdiction over legislation which governs the relationship between treaties and the Code.

I. MODIFICATION OF THE CODE BY TREATIES

It is not the purpose, as such, of U.S. tax treaties to modify Code rules. However, modification of those rules is the necessary consequence of the fulfillment of the treaty's purposes to avoid double taxation and prevent tax evasion. Although the Code itself contains mechanisms to avoid double taxation, these provisions must be general in nature because of the need for them to interact with the widely differing tax regimes of many different countries. The general Code mechanism for the avoidance of double taxation of foreign taxpayers is the general limitation of the tax base to that person's U.S. source income. The general Code mechanism for the avoidance of double taxation on U.S. taxpayers is the foreign tax credit. In any particular case, these mechanisms may provide a poor mesh with a particular foreign country's system. For example, both mechanisms rely heavily on the source of items of income to determine liability. If, under U.S. law, an item of income would be from U.S. sources, while under the law of a foreign country the item would be treated as from sources within that country, double taxation could result. Treaties permit the differing rules of national taxing jurisdiction to be brought into closer correlation, so that income is taxed once, but only once.

Where a Code rule is modified by the United States' agreeing to reduce its tax or to exempt U.S. income received by a foreign investor, the United States usually demands a reciprocal concession by the foreign country to U.S. investors doing business in, or receiving income from, that country. Thus, if a foreign investor would not be taxable on U.S. business income unless he has a permanent establishment here, the United States would also require the treaty to provide that a U.S. investor would not be taxable on business income from the foreign country unless he has a permanent establishment there. Also, withholding rates on investment income are generally reduced reciprocally to the same level, although as to any particular type of income (such as dividends) the foreign treaty country may, under its domestic law, withhold at a rate higher or lower than the 30-percent rate prescribed in the Code.

A. Legal authority for modification of code rules by treaties

Constitutional provisions.—Code rules may be modified by tax treaties because, under the Constitution, both treaties and legislation are the supreme law of the land. U.S. Const., art. VI, cl. 2. Income tax conventions, as U.S. tax treaties are formally named, have been held to be treaties entitled to the protection of the Constitution's supremacy clause. *American Trust Co.* v. *Smyth*, 247 F. 2d 149 (9th Cir. 1957); *Samann* v. *Commissioner*, 313 F. 2d 461 (4th Cir. 1963).

Treaties and statutes are placed on an equal footing by the Constitution, and thus the rules for resolving conflicts between tax treaties and the U.S. tax laws are the same rules as those which govern conflicts between different statutes on the same subject. Legislative enactments may be overruled by subsequent treaties and treaties may be overridden by subsequent legislation. Whenever possible, treaties and legislation bearing on the same subject are read in a consistent manner. *Menominee Tribe* v. *United States*, 391 U.S. 404 (1968); *United States* v. *Payne*, 264 U.S. 446 (1924); *United States* v. *Lee Yen Tai*, 185 U.S. 212 (1902); *Chew Heong* v. *United States*, 112 U.S. 534 (1884); *Head Money Cases*, 112 U.S. 580 (1884). However, where a statute clearly conflicts with a later treaty, the treaty will prevail. *Cook* v. *United States*, 288 U.S. 102 (1933); *Lee Yen Tai* v. *United States*, *supra*. Similarly, a later-enacted statute will prevail over a prior treaty where the conflict is clear. *Whitney* v. *Robertson*, 124 U.S. 190 (1888); *Head Money Cases*, *supra*; *Cherokee Tobacco*, 78 U.S. 616 (1870); *Taylor* v. *Morton*, 2 Curtis 454 (1855). "Nevertheless, the purpose by statute to abrogate a treaty or any designated part of a treaty, or the purpose by treaty to supersede the whole or a part of an act of Congress, must not be lightly assumed, but must appear clearly and distinctly from the words used in the statute or in the treaty." *Lee Yen Tai* v. *United States*, *supra*, at 221.

Treaty rules.—In addition, a number of rules exist in both the Code and treaties which generaly have the effect of giving the taxpayer a choice between the greater benefits of the Code and the applicable treaty. Thus, Article 1(2) of the current U.S. model income tax treaty provides:

> This Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded—
>
> (a) by the laws of either Contracting State, or
>
> (b) by any other agreement between the Contracting States.

A similar provision is found in most U.S. tax treaties now in force.[1]

Because U.S. tax treaties contain a "saving clause" (discussed below) which, with the exception of foreign tax credit provisions, generally allows the United

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[1] The treaties with Ireland, Pakistan, the U.S.S.R. and the 1945 treaty (in force as extended to U.K. territories) do not include such a clause.

States to tax its own citizens, residents, and corporations as though the treaty had not come into effect, most treaty provisions do not apply to U.S. taxpayers in determining their U.S. tax liability (although these provisions may apply in determining their liability for the treaty partner's taxes).

Code rules.—Additionally, the Internal Revenue Code includes two provisions which are intended to minimize conflicts with tax treaties. Section 7852(d) of the Code provides that:

> No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on date of enactment of this title.

Thus, it is made clear that the enactment of the Code in 1954 was not to be construed as abrogating prior treaties, apparently in recognition of the rule that the later enacted or ratified otherwise would ordinarily prevail. This provision apparently also protects the benefits of pre-Code treaties against the enactment of subsequent amendments to the Code. Thus, the Revenue Act of 1962 (discussed below) included a specific provision that the Act was to prevail over any conflicting treaties, notwithstanding section 7852(d). However, section 7852(d) does not apply to treaty obligations which went ito effect after August 16, 1954, the date of enactment of the 1954 Code.

The second provision in the Code (sec. 894(a)) provides that:

> Income of any kind, to the entent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

This provision applies to all treaties, including those entered into prior to the enactment of the Code amendments which would have required the inclusion of an item of income. However, it does not apply to treaty benefits other than exclusions from income.[2]

Although both section 894(a) and section 7852(d) broadly affect U.S. treaties, neither appears to have been intended as a comprehensive rule to guide the relationship between treaties and the Code. Section 894(a), while it affects all U.S. tax treaties, applies only to those treaty provisions which require exemption from taxation. Section 7852(d), while applicable to all treaty obligations, applies only to treaties in force at the time of enactment of the Internal Revenue Code of 1954.

The Congress on other occasions has considered the relationship between treaties and Code amendments and, in at least one instance, has overridden a treaty by legislation. Thus, it was pointed out in hearings on the Revenue Act of 1962 that a number of provisions of the bill might conflict with U.S. tax treaties and that, under section 7852(d) of the Code, certain treaties would take priority over the bill. Among the provisions said to be affected were rules for including currently the tax haven income of controlled foreign corporations in the income of the U.S. shareholders; a rule for "grossing up" dividends received from foreign subsidiaries in connection with computing the foreign tax credit on the dividends; and a rule including in the estates of U.S. decedents their foreign real estate holdings. The Ways and Means Committee added a provision to the bill which stated that the amendments made by the bill would prevail over conflicting treaties. The Senate Finance Committee deleted this provision and substituted a new rule expressly stating that no provision of the bill would apply if it conflicted with any treaty obligation of the United States. In conference, the House position prevailed (sec. 31 of the Act). The only conflict with treaties which the Treasry determined to exist was in the real estate provisions of the Greek estate tax treaty.[3] That treaty was promptly renegotiated to remove the conflict.

The question of the relation between the treaties and the Code arose again under the Foreign Investors Tax Act of 1966. The Act (sec. 110) provided that no amendment made by the Act was to apply in any case where its application would be contrary to any treaty obligation of the United States. However, the granting of a benefit provided by any amendment made by the Act was not considered to be contrary to a treaty obligation and thus would be available.

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[2] Section 894(a) was originally enacted as part of the Revenue Act of 1936 and has been reenacted since. The original reason for enactment was to prevent the Revenue Act of 1936 from overriding the provisions of the tax treaty which had previously been entered into with France. *Revenue Act, 1936: Hearings on H.R. 12395,* Before Senate Committee on Finance, 74th Cong., 2d Sess. 43 (1936).

[3] It has been argued that the provisions of the 1962 Act involved a considerably greater conflict with treaties then in force. See Beemer, "Revenue Act of 1962 and United States Treaty Obligations," 10 Tax L. Rev. 125 (1964).

The rule providing that a provision of the Act which granted a benefit could prevail over treaties laid the foundation for a provision in the Act which in effect rewrote U.S. tax treaties then in force. Prior to the 1966 Act, the United States taxed foreign investors under the "force of attraction" principle. Investors who were not engaged in business in the United States were generally taxed at a flat 30 percent rate on gross income (or, if higher, at graduated rates on net income). If the investor was engaged in a U.S. business, however, he was taxed at graduated rates on all his net income from U.S. sources, even his U.S. income which was not connected with the business and which would have been taxed at flat rates had he not been engaged in business. U.S. treaties were written with this regime in mind.

For example, the Austrian treaty provides that industrial and commercial profits of an Austrian enterprise will not be subject to tax unless the enterprise has a U.S. permanent establishment, but, if it does, the U.S. may impose its tax on all the U.S. source income of the Austrian enterprise, also, exemptions from, or reductions in, tax on various types of passive income apply only if the taxpayer does not have a U.S. permanent establishment. However, as described earlier, the 1966 Act generally changes U.S. taxation principles so that income effectively connected with a U.S. business is taxed at graduated rates, while investment income which is not connected is taxed at a flat 30-percent rate regardless of whether or not the taxpayer also has a U.S. business. Section 894(b) of the Code, added by the 1966 Act, in effect amends all the earlier U.S. tax treaties to incorporate this new principle. That section provides that, if a treaty would reduce or eliminate U.S. tax on income if the taxpayer did not have a U.S. permanent establishment, then he will be treated as not having a permanent establishment with regard to income which is not connected with a U.S. business. This income could therefore qualify for the treaty benefits. Thus, by legislation, the "force of attraction" principle was read out of U.S. tax treaties in situations where such a reading would benefit taxpayers (which generally would be the case).

The 1966 Act also dealt with the relation between treaties and the Code in another way which, although it also did not deprive taxpayers of treaty benefits, did deprive them of certain Code benefits if a treaty exemption or reduction applied to the income. The 1962 Act had added certain provisions to the Code (subpart F) which required U.S. shareholders of a controlled foreign corporation (CFC) to include in their income their share of certain "tax haven" income of the CFC as though it had been distributed to them as a dividend. An exception was made to this rule if the "tax haven" income was effectively connected with a U.S. business. However, the 1966 Act restricted this exception so that it was unavailable where the U.S. income was subject to exemption or a reduced rate of tax under a treaty. (Code sec. 953(b)).

The Tax Reduction Act of 1975 and the Tax Reform Act of 1976 made a number of changes to the rules governing the computation of the foreign tax credit (in particular, they eliminated the option to compute the credit on a per-country basis and required that the overall limitation be used in all cases.) Although it is not at all clear to what extent Code rules as changed by these Acts conflicted with any U.S. treaty obligations, the changes overrode any treaty provisions to the extent they were inconsistent. The General Explanation of the Tax Reform Act of 1976, in its discussion of the changes made by that Act to the foreign tax credit rules, states:

> The Congress further intends that, as is the case with other recent legislation modifying the foreign tax credit, the changes made by the Act are to be used in computing the credit allowed under all treaties.

Materially identical language appears in the committee reports on the Act.[4]

Recently, the conferees on the Crude Oil Windfall Profit Tax Act of 1980 stated in their report that they were unaware of any U.S. treaty obligations which would conflict with the Act but, if there were such a conflict, the conferees intended that the legislation prevail. H.R. Rep. No. 96-817, 96th Cong., 2d Sess. 106 (1980). Also, three bills reported in December 1979 by the Senate Finance Committee which would tax real property gains realized by foreign investors, H.R. 1212, H.R. 1319, and H.R. 2297, each provide that any conflicting U.S. treaty obligations would prevail over the legislation for five years, after which the legislation would take precedence over the conflicting treaties.

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[4] H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 226 (1975) ; and S. Rept. No. 94-938, 94th Cong., 2d Sess. 237 (1976)

Modification of code rules: Foreign taxpayers

Many treaty rules, while reciprocal in form, affect U.S. tax liability only for foreign taxpayers. As noted earlier, the "saving clause" in U.S. treaties generally withholds the benefits of these provisions from U.S. taxpayers in determining their U.S. tax liability. (In the case of U.S. taxpayers, the primary impact of the treaties is in modifying their tax liability to the treaty partner.) However, these treaty provisions do have an important effect on the rules affecting U.S. taxation of foreign investors. In general, the treaty rules require a more significant presence in the United States before a foreign investor may be taxed on his active business income. In the case of passive investment income, the treaties frequently reduce or eliminate U.S. withholding taxes.

Active business income.—Under the Code, income from U.S. sources is subject to tax at the graduated rates which apply to U.S. domestic taxpayers if the income is effectively connected with the conduct of a trade or business within the United States. (However, the taxpayer's foreign income which is not subject to U.S. tax is not taken into account in determining the applicable rates of tax.) In addition, certain foreign source income may also be subject to tax if, for example, it is attributable to a U.S. office of the taxpayer.

U.S. treaties generally provide, however, that the business profits (sometimes the treaties refer to industrial or commercial profits) of a foreign taxpayer are not taxable by the United States unless they are attributable to a "permanent establishment" within the United States. The definition of "permanent establishment" varies from treaty to treaty but generally would include, for example, an office, branch, or factory. It is possible to be engaged in a U.S. trade or business, but not to have a U.S. permanent establishment. This was the case, for example, in *Inez de Amodio*, 34 T.C. 894 (1960), where a foreign individual owned income-producing real property in the United States and managed it through independent real estate agents.

Personal services.—Generally, under the Code, income from the performance of personal services within the United States is subject to tax at the graduated rates which apply to U.S. domestic taxpayers. A de minimis exception is made where the taxpayer is in the United States for 90 days or less during the taxable year, works in behalf of a foreign employer not engaged in a U.S. business, and is paid no more than $3,000 for the U.S. services. Under the more recent treaties, individuals performing independent personal services are generally taxable only if the earnings are attributable to a "fixed base" they maintain in the United States or the individual is present in the United States more than 183 days during the taxable year. Employees generally are not taxable if they are in the United States 183 days or less in the taxable year and are paid by foreign employer, if the expense is not borne by a U.S. permanent establishment or fixed base of the employer. Thus, in the case of an employee, a greater U.S. presence by both the employer and the employee is required, and generally there is no dollar limitation on the compensation received.

In addition, many treaties provide special rules for students, trainees, teachers, artists and athletes.

Investment income.—Periodic investment income (e.g., dividends, interest, rents, royalties) not connected with a U.S. business is generally subject under the Code to tax at a flat rate of 30 percent on the gross amount of the income (i.e., without the allowance of deductions for expenses incurred to produce the income). Capital gains not connected with a U.S. business are not subject to tax except in the case of a nonresident alien who is present in the United States 183 days or more during the taxable year.

In some cases, the expenses of producing investment income may be considerable. This is particularly true in the case of rental income from improved real estate. The Code permits a foreign investor an irrevocable election to treat his U.S. real estate income as though it were connected with a U.S. business. This allows him to pay tax at the usual graduated rates on that income net of deductions, but it also requires him to pay tax on the gain recognized on sale of the property. The expenses of earning other types of passive income may also be significant, e.g., dividends paid by stock bought on margin will have associated interest deductions. However, the Code has no rule permitting deductions to be taken in these cases.

U.S. tax treaties generally deal with the possibility of double taxation by retaining the concept of a flat tax enforced through withholding at the source on passive investment income, but reducing the rate. Thus, for example, while many U.S. treaties retain a 30-percent rate of tax on interest, interest generally is exempt under treaties with Austria, Denmark, Finland, Germany, Greece, Hungary, Iceland, Ireland, Luxembourg, Malawi, Netherlands, Netherlands Antilles, Norway, Poland, Sweden, U.S.S.R., United Kingdom, and Zambia. Reciprocal reductions in rate are provided under treaties with Belgium, Burundi, Canada, Rwanda, and Zaire (15 percent), Korea (12 percent) France, Japan, and Romania (10 percent) and Switzerland (5 percent).

The rate on dividends is generally reduced to 15 percent under the treaties, and further reductions to 10 or 5 percent are often applicable to dividends paid to a parent corporation. Royalties are generally exempt from tax, and the rate on real property income is often reduced to 15 percent.

Most U.S. treaties do not contain provisions relating to capital gains, in part because these gains generally are not subject to tax by the source country. However, more recent U.S. treaties generally follow the OECD model in exempting capital gains which are not from real estate or from property of a permanent establishment or fixed base.

Shipping income.—The Code provides that foreign ships owners are exempt from U.S. tax on U.S. source shipping income as long as the income is derived from the operation of a ship documented under the laws of a foreign country which grants an equivalent exemption for the shipping income of (or imposes no tax on the income of) citizens and corporations of the United States. The determination that a foreign country grants an equivalent exemption is usually made by an exchange of notes between the two countries. Even in those cases where a reciprocal exemption under the Code or a treaty is not in effect, relatively little tax is imposed on the international shipping profits of foreign corporations since the present source rules for shipping income treaty only a relatively small protion of the total international shipping income as from U.S. sources.

U.S. tax treaties also generally provide for a reciprocal exemption which would exempt shipping from taxation by either country even if there were no statutory exemption. (Although there is substantial overlap, the scope of the threaty reciprocal exemption is somewhat different than the statutory reciprocal exemption.) There treaties are in effect with virtually all of the developed countries and with most of the signficant maritime countries of the world, including the United Kingdom, Germany, France, Japan, Norway, Greece, and the Soviet Union.

C. Modification of code rules: U.S. taxpayers

As previously noted, the "saving clause" in U.S. tax treaties makes many treaty provisions inapplicable to U.S. citizens, residents, and corporations. However, treaty provisions dealing with the allowance of a foreign tax credit generally are not subject to the saving clause.

All U.S. tax treaties (except the treaty with the U.S.S.R.) have a provision dealing with the allowance of a foreign tax credit. The United States agrees to include these provisions not to benefit U.S. taxpayers, but because the foreign treaty partner seeks assurances that the income taxes which it imposes will not result in double taxation of U.S. businesses investing within its borders. Such double taxation would impede U.S. investment in the foreign country, where as U.S. treaty partners generally would prefer to encourage that investment.

Similarly, the United States seeks assurances that the foreign treaty partner will grant a foreign tax credit for U.S. income taxes so that enterprises of the foreign country will not be discouraged from investing in the United States.

Treaty credit articles modify applicable Code rules in a number of ways. The most significant aspect of the more recent U.S. treaties is that they clearly provide that certain foreign income taxes covered by the treaty will be treated as creditable income taxes for purposes of the Code. Thus, for example, the recently ratified treaty with the United Kingdom provides that the U.K. Petroleum Revenue Tax ("PRT") will be treated as a creditable income tax. (However, this provision is subject to a special limitation to prevent the treaty benefits from being used to offset U.S. tax liability on foreign income other than U.K. source income subject to the PRT.) U.S. taxpayers may use this provision to claim a credit for the PRT even though the IRS has ruled that, in the absence of the treaty, the PRT would not be a creditable income tax. (Rev. Rul. 78–424, 1978–2 Cum. Bull. 197.)

The wording of the credit articles in older U.S. treaties generally differs from that in the newer treaties. As a result, there is some disagreement as to whether these older treaties also provide a foreign tax credit for covered taxes independently of the Code requirements. There have been no court cases on this point. Many of the interpretations of the Treasury, IRS, and Congressional committees are ambiguous on this issue and in most cases it appears that the authors were not focusing on it.

Some U.S. treaties also prescribe detailed rules for determining the country of source of various items of income. While these generally parallel the Code source rules, to the extent that there are differences, the allowable foreign tax credit may be affected. This is because the allowable credit is limited to an amount equal to the U.S. tax on the taxpayer's foreign-source income. An increase in income attributed to foreign sources could thus increase the allowable foreign tax credit. (These source-rule modifications may also be relevant in determining the amount of income of a foreign taxpayer which is subject to U.S. tax.)

Some older U.S. tax treaties may also affect the manner in which this limitation on the foreign tax credit is computed. The tendency in more recent treaties, however, has been to avoid placing restrictions on the computation method which the United States may use by amending the Code from time to time, so long as the method does not change the general principle of the treaty credit article. Thus, for example, under the more recent treaties the United States may continue to compute the limitation on an "overall" basis, averaging the taxes and foreign income from all overseas operation, or, if the Code were amended, it may revert to the "per country" limitation, under which the limit is applied on a country-by-country basis. (The per-country method has been optional or mandatory in the past.)

D. Administrative Provisions

Mutual agreement.—Sometimes the United States and the other partner to a tax treaty may apply their laws and the treaty in a manner which still results in double taxation of the same income because of inconsistent positions of the treaty partners. By far the most important example of a situation of this type is the reallocation of income between related parties (or between a corporation organized in one country and its branch in the other). For example, suppose a U.S. parent corporation sells partially assembled goods to a subsidiary corporation in a treaty country. The subsidiary then finishes the assembly and sells the goods to unrelated purchasers. The IRS may assert that the U.S. parent, had it been dealing with the subsidiary at arm's length, would have charged more for the goods. The IRS may make an adjustment increasing the parent's income to reflect the amount which should have been received. (This adjustment may be made under section 482 of the Code. Treaties also generally provide that, for purposes of applying their provisions, adjustments may be made between related enterprises so that the profits of each include profits which would have been earned had they dealt with each other independently.) Such an adjustment increasing the amount deemed received by the parent should call for a correlative adjustment increasing the amount deemed paid by the subsidiary. This would, of course, decrease the subsidiary's income. However, the tax authorities of the foreign treaty partner may not agree that the subsidiary paid too little for the goods. If they fail to make the correlative adjustment reducing the subsidiary's income, then the subsidiary is taxed by the treaty partner, and the parent is taxed by the United States, on the same income.

In situations such as this, the taxpayers may request that the tax authorities of the two countries attempt to reach an agreement between themselves as to the correct liabilities of the taxpayers. In the case of the United States, this function is under the jurisdiction of the IRS Assistant Commissioner (Compliance). Frequently, the result of consideration under this procedure will be reduction or elimination of the adjustment which the IRS had proposed to make in the taxpayer's income subject to U.S. tax.

Tax treaties also permit the tax authorities of the two countries to exercise certain other functions. For example, many treaties expressly provide that the tax authorities may establish a common meaning for undefined treaty terms, particularly where those terms have different meanings under the domestic laws of the two treaty partners.

Exchange of information.—U.S. tax treaties also generally provide for the exchange of information between the tax authorities of the treaty partners. This exchange is generally of two types. First, there may be routine information reporting to the treaty partner. For example, U.S. law generally provides that the payor of interest is required to file an information return with the IRS. If the return shows that the recipient is in a treaty country, the IRS frequently will pass along this information to the treaty partner. Similarly, the IRS receives information returns from a number of foreign countries. Questions have been raised, however, as to whether these documents are in a form which enables them to be utilized effectively by the IRS. Moreover, some tax haven countries take the position that they do not have the resources to provide routine information exchanges.

In addition, tax authorities of one country may request specific information from the other relating to a particular taxpayer. A request for information by Canada under the U.S.-Canada treaty was upheld in *United States* v. *A. L. Burbank & Co.*, 525 F.2d 9 (2d Cir. 1975), *cert. denied*, 426 U.S. 934 (1976), even though only Canadian, and not U.S., tax liability was at issue.

The treaties generally provide that information may not be obtained except in accordance with the domestic laws of the treaty partners. Thus, enforcement of an IRS summons was recently refused where the IRS was attempting to obtain information for Norway and the U.S. government failed to show that Norway could obtain information under its domestic law in similar circumstances. *United States* v. *Lincoln First Bank, 80–1 U.S.T.C. ¶ 9231* (S.D.N.Y. 1980). Also, the information may only be used by tax officials and generally is to be kept secret, although it may be admitted in judicial proceedings.

It is considerably more difficult to obtain information under some treaties than others. For example, under the treaty with Switzerland, certain information may be obtained only to prevent "fraud or the like." The Swiss concept of tax fraud is considerably narrower than the U.S. concept. Moreover, Swiss law provides only limited power to tax officials to require the production of documents. Since the Swiss need not provide information which cannot be obtained under their domestic law, this too limits the information which the United States may obtain.

E. Estate and gift tax treaties

The United States currently has estate tax treaties with 13 foreign countries. Treaties relating to gift taxes are in effect with three of these counries. These treaties generally serve functions with respect to estate and gift taxes which are similar to the functions served by income tax treaties. They are also negotiated and ratified pursuant to the same procedures as income tax treaties.

In general, these treaties permit only one of the two treaty partners to impose its tax on property in situations where, under the domestic laws of the treaty partners, both might claim taxing jurisdiction. If the country which may not impose its tax on a particular property under the treaty taxes on a worldwide basis (as is the case with the United States), it generally is required to give a credit against its tax for the tax imposed on that property by the other treaty partner.

Usually, the country of the taxpayer's domicile is given the exclusive right to tax under the treaty, but in some cases (e.g., real property), the country of situs has the exclusive right. Where both countries would, under their domestic law, treat the taxpayer as a domiciliary, the treaties provide rules to establish one of the two treaty partners as the country of domicile.

Like income tax treaties, these treaties provide mutual agreement procedures and rules for the exchange of information.

F. Social security totalization agreements

Although not strictly "treaties," another form of international agreement affecting tax liabilities is the Social Security "totalization" agreement authorized by section 317 of the Social Security Amendments of 1977. The United States thus far has concluded totalization agreements with Italy, West Germany and Switzerland. The law authorizing these agreements prescribed certain provisions which they must contain. In general, periods of coverage under the social security systems of the United States and the other country involved are aggregated to determine qualification for benefits and dual coverage for the same employment is eliminated. Benefits payable under U.S. Social Security on the totalized credits are prorated based on the proportion of periods of coverage under the U.S. system to total coverage. The individual involved is exempted from paying social security taxes to one country while he is required under the agreement to pay them to the other country.

These agreements are referred to Congress and go into effect unless either House adopts a resolution of disapproval. In the House, they are referred to the Ways and Means Committee; in the Senate, they are referred jointly to the Foreign Relations and Finance Committees.

II. STEPS IN THE NEGOTIATION AND RATIFICATION OF TAX TREATIES

Negotiators.—Tax treaties (and protocols to existing tax treaties) are negotiated by the Office of International Tax Affairs of the Treasury Department with the assistance of Internal Revenue Service personnel. Ordinarily, the involvement of the State Department at the negotiator's level is only peripheral, although the law requires that the State Department be consulted prior to the signing of any treaty. Foreign negotiators ordinarily are representatives of the foreign tax authorities.

Model treaties.—U.S. negotiators start from the U.S. model income tax treaty (or, in the case of an estate and gift tax treaty, the U.S. model estate and gift tax treaty), which is a public document prepared by the Treasury Department setting out the preferred U.S. position on each article. The model income and estate tax treaties of the Organization for Economic Cooperation and Development (the OECD) also are used as guides.

Other precedents.—The Treasury generally will also take into account recent expressions of Senate views on matters covered by other treaties. For example, the Senate refused to agree to the recently ratified treaty with the United Kingdom until a provision which would have restricted the taxing authority of the State was deleted. France thereafter asked that a similar provision be included in a protocol to its treaty with the United States. The U.S. negotiators made it clear, however, that they could not agree to such a provision in light of the Senate's action on the U.K. treaty. Similarly, the Treasury will not agree to "tax sparing" provisions in treaties with developing countries because of the Senate's rejection of such provision in treaties before it in prior years.

Public comments to Treasury.—Treasury announces that it intends to negotiate a treaty with a particular foreign country or renegotiate an existing treaty, and this gives interested parties an opportunity to comment. Also, Treasury has recently introduced a policy of having public sessions after negotiations have made substantial progress at which it outlines the issues involved in the treaty and the possible solutions (but not the specific terms of draft language) and solicits the views of interested parties.

Initialling of treaty text.—After the text of the treaty is agreed to, it is initialled by the negotiators. The initialling is not of a binding nature but merely serves to identify the text agreed upon at the negotiator's level. Textual changes may be made after the draft is initialled.

Signing of treaty.—After an official translation of the text is completed and the text is approved for form by the State Department, it then is signed by the appropriate officials of each government. (In the case of the United States, this is ordinarily the Secretary of State or the U.S. Ambassador to the foreign country.) After signature, Treasury publicly releases the treaty text.

Letter of transmittal.—The treaty is then sent to the White House for signature by the President of the letter of transmittal to Senate requesting approval of the Senate to ratification by the President.

Senate Committee on Foreign Relations.—The tax treaty is referred by the Senate to the Committee on Foreign Relations, which conducts hearings on it. After the committee's deliberations it may report the treaty to the Senate floor the recommendation that the treaty be approved as negotiated, or that the Senate approve the treaty with certain amendments, reservations, or understandings. The committee may also decline to report the treaty favorably.

The Foreign Relations Committee and its staff is assisted in its consideration of the treaties by the staff of the Joint Committee on Taxation. The Joint Committee staff generally prepares explanations of the terms of the treaty and, where possible, background information on the reasons for which provisions were incorporated in treaties, particularly where these provisions have not been incorporated in prior treaties.

The staff also presents testimony on these matters and answers Senators' questions. Staff assists in the preparation of committee reports on the treaties by providing explanations of the operation of their provisions. In general, this assistance is of the same type which the staff provides to the tax-writing committees.

Senate deliberation.—Following committee action, the treaty is reported to the full Senate which must advise and consent to its ratification by a vote of two-thirds of the Members present. Individual Senators may offer amendments, reservations, or understandings after the Senate has acted upon any amendments, reservations, or understandings proposed by the Committee on Foreign Relations. Any votes to be taken by the Senate on any amendments, reservations, or understandings require a majority with the exception of a motion to table the proposed tax treaty, which requires a two-thirds vote.

Ratification.—If the treaty is approved without reservation or amendment, the President may then exchange instruments of ratification with the foreign government (assuming the foreign government has also completed its internal procedures which must be carried out before it can ratify the treaty).

Revision of existing treaties.—Where it is determined that changes to an existing tax treaty would be appropriate because the treaty is outdated in certain respects (for example, where there have been changes in the tax laws of either country since the existing treaty was negotiated), the changes may be made by revising the treaty with a protocol. Where, however, the changes are substantial enough, a new treaty may be negotiated to replace the existing treaty.

Mr. **Gibbons**. Mr. Brockway, are there any major countries in the world that have not entered into tax treaties with the United States?

Mr. **Brockway**. As far as I know, almost all the major industrialized countries are covered. We do not have a tax treaty with China. Other than that, I would say that almost all——

Mr. **Gibbons**. We have them with Japan and Korea. How about Russia?

Mr. **Brockway**. We have treaties with Japan, Korea, and Russia, almost all the countries of Western Europe, and a number of countries in Eastern Europe. We do not have many treaties with developing countries. There are several and Treasury is attempting to negotiate some more as later witnesses will point out. There are different considerations involved in the case of treaties with developing countries. Since developing countries do not have a great deal of investment in the United States, they do not have that much interest in tax treaties.

Mr. **Gibbons**. Looking at U.S. domestic tax policy, what principal changes have tax treaties made on domestic policy? Do we have any glaring exceptions or anything like that?

Mr. **Brockway**. I would say treaties by and large follow domestic policy. I think there are a number of situations where they do not, but by and large they are isolated changes. The most important, or at least most publicized, impact of treaties is the exemption for interest income. It is our negotiating position to relieve our tax on interest paid to foreign residents if the foreign government agrees to give up taxation of U.S. persons receiving interest from those sources.

Those provisions have been used principally through the Netherlands Antilles to permit U.S. companies to set up finance subsidies in Netherlands Antilles to issue corporate bonds to foreign investors without any withholding tax. The impact of those provisions is that at the moment we pick up relatively little tax revenue from the withholding tax on interest, maybe $40 million a year, because if someone is serious about not paying the tax it is a fairly simple thing to arrange their affairs to invest in the United States and not to pay that tax.

There are other examples where there is a type of tax which foreign investors basically do not have to pay as the result of U.S. tax treaties. The taxation of capital gains is an area where treaties have an impact insofar as we are now trying to change the law but they do not have much impact on present law.

There are some situations dealing with the foreign tax credit where treaties have an impact. For example, the recently ratified United Kingdom tax treaty gives a credit for United Kingdom petroleum revenue tax and there is some dispute as to the credibility of that. IRS has ruled it is not a creditable tax.

Obviously taxpayers do not agree with that but the treaty provides that it is a creditable tax notwithstanding the IRS position. That is a very significant provision. The upcoming treaty with Morocco and the one that is under negotiation with Israel give a foreign tax credit for forced loans to those countries which clearly are not income taxes. There is no dispute they are not income taxes and yet they would be allowed the foreign tax credit under the proposed treaties. So these are departures from our principles but they are isolated. You have a whole series of examples like these but they are pretty much limited situations.

You also have different concepts in the treaties as compared with the code concepts. For instance, we do not tax foreign business operations of foreign companies. In the treaty we adopt international rules and say we will not tax foreign businesses under their business income is attributable to a permanent establishment in the United States, basically an office or branch. Our code rule is that we will not tax their income unless it is effectively connected with U.S. trade or business. Now, I think the general viewpoint is that the code rule is a little broader than the treaty rule although it is not exactly clear what the United States Code rule means. In large part, however, almost all investment in the United States comes under a treaty jurisdiction anyway so it is what the treaties provide that controls. The treaties use different terminology and slightly different concepts, but essentially they accomplish the same thing as the code rules do.

Mr. **Gibbons.** Who are the principal U.S. beneficiaries of the tax treaties?

Mr. **Brockway.** I would assume that the principal benefit the U.S. taxpayers get under the tax treaties is the benefit they get in reduced tax rates of the foreign government on U.S. investment overseas. While U.S. portfolio investors overseas get reductions in foreign rates under the treaties, my guess is that if instead they paid the full foreign tax, most of them would have adequate foreign source income to use for the foreign tax credit and thus they receive no net benefit. However, I think direct investors frequently are in or nearly in an excess credit position and thus they get a substantial benefit from reductions in the foreign tax. They also get the benefit of receiving a clear notion of what tax they have to pay in the foreign jurisdiction. It is difficult enough under U.S. law to know what your tax liability is and when you go to a foregn jurisdiction, it is very helpful to have a clear set of rules.

So I think the U.S. taxpayer basically gets these types of advantages. They are not from the United States except the United States is giving up equivalent benefits to the taxpayers from those jurisdictions. That is the major impact of the treaties.

Mr. **Gibbons.** Have tax treaties encouraged American manufacturing business to go overseas?

Mr. Brockway. I wouldn't think so realistically. Only insofar as our code structure does and obviously there is a big debate as to whether one thinks our code rules do or do not.

The principal issue, I think, in these debates as to whether our tax system results in operating overseas, is deferral, and the treaties do not grant anything additional along those lines.

The other major item in these debates is the foreign tax credit. There are some recent treaties that clearly provide that covered taxes qualify for the foreign tax credit. There is some question under some of the earlier treaties as to whether the treaties add a great deal, but in either case, the taxes covered by the treaties in almost all situations are taxes that qualify for foreign tax credit under the statute, so again the code and treaty rules tend to parallel.

So, if the treaty rules encourage investment overseas I would assume the code rules do also. My guess is that treaties are fairly neutral.

Mr. Gradison. Mr. Brockway, there has been some discussion in this committee as well as in the Senate Finance Committee about the possibility of our imposing a capital gains tax on foreign investors who realize gains on sales of real estate in this country. What would the effect of that be on existing treaties?

Mr. Brockway. You have two aspects to that. One, there are provisions to tax real estate held directly by the foreign investor. Second, the added component of all the legislative proposals to date is to tax foreign investors on capital gains on sale of stock in corporations holding U.S. real estate. You need to tax sales of stock because, if you do not, the act would basically result in no tax because under our system any tax could otherwise be avoided through liquidation of the corporation.

As far as the taxation of direct investors goes, the only treaty now in force that would limit U.S. taxation of direct investors would be the treaty with Canada and that is under negotiation. Canada has amended its law to tax foreign investors in Canadian real estate and is interested in changing that provision in the treaties so far as I understand, so even that provision will, I assume, be removed in due course.

Then there are about 10 to 15 treaties that would restrict the right of the United States to tax sales of stock, whether or not they are sales of stock in corporations owning real estate. As reported by the Finance Committee the legislation would not override the treaties for 5 years. If they could not be renegotiated in that period, the legislation would override the treaty.

Mr. Gradison. In a case like this, when in some instances the law may override a treaty, are there any standard provisions of the treaties themselves which would force them to be reopened or canceled or cause new negotiations to take place when we or the other countries unilaterally make a change in domestic laws which overrides the treaty?

Mr. Brockway. Some of the treaties have provisions that require notification of significant changes in the law but I would assume that would happen in any event. In this situation, clearly Congress could provide for notification in the real estate legislation itself, but I have no doubt Treasury would do this in any event—notify the foreign governments that this change, in fact, had occurred and ask them to renegotiate.

I am also sure that the foreign governments would know anyway. The treaties all have provisions for terminating the treaty unilaterally so that the foreign government, on something like 6 months notice, can unilaterally terminate the treaty.

On legislation with a 5-year delay in the effective date, if it were not possible to renegotiate the treaty within the 5-year period and the foreign government were not willing to accept the change that Congress thought appropriate, it could terminate the treaty.

You have a difficult problem where there is one provision in the treaty that the foreign government does not like but it wants the treaty otherwise. They do not want to give up the treaty benefits. It might be the same on our side; we might not want to terminate the treaty because we could not come to agreement on this one issue. The inability to reach agreement might also be on unrelated points. We have a number of treaties where we have difficulty in reaching agreement with the foreign government and this issue is likely to become tied up in it.

So it may not be easy to deal just with this real estate matter in a protocol. The practical way of dealing with this situation is to let the legislation go into effect even if the treaty is not renegotiated. The assumption is that after a 5-year period the foreign government has more or less agreed to what the situation is. They have had adequate time to protect themselves.

You do have a problem to the extent we override tax treaties, of making it difficult for the United States, either in the case of tax treaties or in other areas, to persuade foreign countries to respect their treaty obligations with the United States. There is no doubt you have that problem but at a certain point one has to resolve the fact that we do have these two separate rules and if Congress is to set tax policy, I would assume there has to be some way Congress can initiate changes in tax policy.

I understand that this device that has been used in the real estate bill, the Senate bill, has generally not been objected to. There may be some problem with it abroad. We might limit the situations where the override would apply but my understanding is that Treasury does not have difficulty with it and, from other people I talked to, it seems it will not create a significant problem.

Mr. Gradison. The taxwriting committees are not directly involved in the approval of tax treaties. Does the Joint Taxation Committee staff have any informal involvement with the Treasury in connection with development of treaty policy and/or the negotiation of specific treaties?

Mr. Brockway. I would say very informally. We have, I think, a very good relationship with the Treasury Department and we talk to them regularly about tax policy. In this area we discuss treaty policy but we are not deeply involved in the formulation of treaty policy or the negotiation of treaties.

We do talk from time to time about what Treasury is doing in the area but we are not in a position to speak for what the Senate Foreign Relations Committee is going to do. Although we do staff work for the Foreign Relations Committee on the treaties, I do not always have a clear idea of what the committee is likely to do on treaties and I cannot speak for it, so it is difficult to have too substantial an involvement in the formulation of treaty policy.

From time to time the proposals have been made, particularly in Congress, to make that consultation process a little bit closer, but at the moment we do it fairly informally and I think it is effective.

Given the role we have as staff, it is very difficult for us to do more than just talk. They have the obligation to negotiate the treaties and if we were to be too heavily involved in that, I think it would interfere with our independence as congressional staff. So I do not know that there is much room for making our relationship a great deal closer.

Mr. **Gradison.** Finally, I want to inquire about this question of credits against U.S. taxes for foreign income taxes paid by American companies. As you know, there is a lot of talk about this and a lot of thought that we can raise a great deal of revenue by making changes in our laws or regulations on the subject.

As you also know, I have been puzzled by the difficulties I have had in just simply getting from the Treasury a list country by country of what the rules of the game are right now, the present law, the present regulations, with regard to which payments are creditable and which ones are not.

Could you comment in a broad way on the extent to which tax treaties bear upon the credibility against U.S. income taxes for such taxes paid, especially in the oil industry?

Mr. **Brockway.** I think in the oil area particularly the treaties do not have much of an impact because most oil extraction operations are not in treaty countries although there are a number of significant oil-producing areas where we do have tax treaties applying—the North Sea and the Netherlands, for example.

As you know, we are in the process of doing studies—they are in galley and I think your staff has copies—trying to determine the impact of the proposed regulations and the tax treaties on the foreign tax credit. It is a very difficult job. One of the things I think Treasury is working on now is trying to determine what they think the appropriate rules are and that is what they have been devoting their time to rather than the studies.

I think the proposed regulations they issued last year were just that, proposed, and Treasury has been fairly busy trying to refine those. We have been going through the process of trying to apply those to the foreign taxes paid by the oil companies. It is very difficult to tell exactly what the foreign system is and to apply any detailed set of rules.

When we do issue our report, I think we will have established what we understand the rules to be. It is very difficult to tell at any given time what the impact is.

So far as the treaties having impact on the foreign tax credit, many recent treaties have explicitly provided that certain taxes covered are income taxes for purposes of foreign tax credit provisions. Of particular importance in the oil area is the petroleum revenue tax imposed by the United Kingdom.

Prior to 1970, the treaties did not really focus in on the question of whether they were providing an independent credit, that is whether they would give a credit for a payment whether or not under the code it was a creditable tax. I am not saying the earlier treaties do not provide an independent credit, but what I am saying is that it is fairly clear the negotiators were not thinking about the issue, that it was not an issue in anybody's mind. There is some question in some of the treaties how you would interpret them to grant a treaty for taxes which would not be creditable taxes under the code.

The regulations themselves do not change the treaty provisions at all. You have to assume if the regulations control, they control because they represent what the courts' view of the law is. Congress said in 1918 that you get a tax credit for foreign income tax and the regulations are merely interpreting that language. If the code allows a credit, then the regulations can't deny it. The regulations control only to the extent the courts will accept them.

So, I do not see the regulations themselves as really changing the conflicts between the code and the treaties and granting a credit or taking away a credit provided in the treaty or vice versa.

The regulations do have a number of rules that would appear to have an impact on the credit for taxes covered by treaties. For example, they have a rule which provides that if an income tax is related to another noncreditable payment, you are treated as paying only the noncreditable payment. That rule comes up in the Netherlands. Substantial taxes are paid by certain U.S. oil companies to the Netherlands where the treaty clearly provides an independent credit for Netherlands income taxes. The U.S. oil companies pay the income tax, but it is allowed as an offset against a higher special levy which is not income tax.

You then have the question as to whether the regulations apply—the treaty says the tax is creditable but the regulations say you are not paying that treaty tax. What happens? I think that at least the position of the Government is that the regulations do apply and there is not any creditable tax paid. These notions have not been tested in court so the extent to which the regulations have an impact in that way is not yet clear.

Mr. Gradison. Thank you, Mr. Chairman.

Mr. Gibbons. Mr. Duncan?

Mr. Duncan. I have no questions. Thank you, Mr. Chairman.

Mr. Gibbons. I am trying to understand, Mr. Brockway, a little better what is the purpose of having a tax treaty with Cyprus and Malta. Those two are proposed now.

Mr. Brockway. They have not been up for review in the Foreign Relations Committee and we have not had substantial discussions about those treaties with the Treasury.

I am not sure what were the motivating factors other than I think in part it is that it is the Treasury Department's position that they are generally in favor of entering into tax treaties to set out clearly what our relationships are with foreign countries and if there is a foreign country that is willing to agree to a treaty along the lines that Treasury thinks are appropriate and that the Senate has agreed to, they will enter into the treaty.

I guess that is what has happened in those two jurisdictions. They wanted a treaty. I have a feeling that perhaps the State Department and others think it is a good idea to have tax treaties just to get closer ties with foreign jurisdictions.

There is no doubt at least with respect to Cyprus, which is a tax haven, that there is a real problem with having a tax treaty. There is a real question whether one is appropriate. I do not know whether that is the situation in Malta. I gather with respect to the Cyprus treaty that Treasury has gone to some significant lengths—I have not seen the language yet—to prevent abuse of that treaty because Cyprus is a tax haven.

But even if you have treaty provisions that would presumably restrict the abuse of the treaty, there is also a question as to whether there is going to be a great deal of cooperation. I understand that we do not have total unfailing cooperation by, let's say, the Swiss or the Netherlands Antilles tax authorities on all matters and perhaps if Cyprus' business is to act as a tax haven, they will have less than 100 percent interest in cooperating with the U.S. tax authorities on all points.

But I do not know. We have not been involved in that at all.

Mr. Gibbons. What are the principal tax haven countries?

Mr. Brockway. I think there is a whole number of them. They change from time to time. I think they also depend upon whose taxes are being avoided or evaded.

In the case of the United States I think the most important tax havens are Caribbean ones. Netherlands Antilles is an important tax haven and I think more or less that is a situation where it is legal tax avoidance, dependent upon the treaty relationship. The Caiman Islands are important, Bahamas are important. There is a real question with the legality of some of the transactions in those situations.

Mr. Gibbons. How about Liechtenstein?

Mr. Brockway. It is an important tax haven. Like Switzerland, it is probably much more important for the European countries than for the United States, but there is no doubt that it is an important tax haven. I think Liechtenstein has the highest per capita income in the world and on their being a tax haven. There was a "60 Minutes" show on this about 6 months ago where representatives of Liechenstein were saying they do not feel their position is to worry about whether people commit tax fraud in other jurisdictions. That is not their problem. Like the other tax havens they have strict bank secrecy laws to make sure that our tax authorities or, say, the German tax authorities, for whom I think Liechtenstein is a principal area of concern, cannot find out information.

I think there are probably 10 to 15 tax haven jurisdictions—the Channel Islands, Jersey is important to the United Kingdom. Nauru is which some place in the South Pacific. The New Hebrides. There are all sorts of them.

The ones that seem to be important to the United States are the Caribbean. To a certain extent, particular by for foreign investors coming into the United States, Liechtenstein, or Switzerland.

Mr. Gibbons. Is Bermuda a tax haven?

Mr. Brockway. My understanding is they are not but that impression is based solely on discussions in the committee last year. I cannot remember which matter was up; the committee was talking about exchange of information agreements and the discussion went on about Bermuda and the Bahamas. The Bahamas clearly are a tax haven. Representatives from Bermuda were present in the committee room and they wanted to make it clear that Bermuda was not a tax haven, that we were getting them confused with the Bahamas.

They said they would be happy to enter into agreements with the United States for exchange of the information. I do not know whatever happened with that. I do not think there have been discussions with Bermuda.

Mr. GIBBONS. Is Ireland a tax haven?

Mr. BROCKWAY. Ireland has tax holidays for investments in Ireland. If you set up a factory in Ireland, they will exempt you for a period of, say, 15 years on your income from export operations.

But as far as I know they are perfectly cooperative in exchanging information. I don't think they have bank secrecy laws. It is not set up for tax evasion.

Mr. GIBBONS. Does a tax treaty inhibit or encourage the establishment of a tax haven?

Mr. BROCKWAY. Well, certainly in the case of the Netherlands Antilles without a tax treaty the entire relationship would be changed. Much of the business done through Netherlands Antilles and the British Virgin Islands is dependent on the treaty.

Certain investments through Switzerland are dependent upon the treaty relationship. In fact, the United Kingdom can be, or at least it formerly was, in effect, a tax haven for investments in the United States. Through United Kingdom trusts, they are dependent on the treaties for certain advantages.

It really depends on whether you are talking about legal tax avoidance or tax evasion, treaties facilitate the former but not the latter.

Mr. GIBBONS. Did the Netherlands Antilles treaty come about because of our treaty with the Netherlands or is it a special treaty?

Mr. BROCKWAY. It is a protocol which extended the Netherlands treaty to the Antilles. I am not sure what the legal relationship of the two is, but I think there is still a close legal relationship between the Antilles and the Netherlands. The Netherlands is a jurisdiction which encourages the use of its treaties for holding companies of third-country businesses. The combination, the use of both the Netherlands Antilles treaty and Netherlands treaties together, is frequently done. It has certain advantages.

That is something I think the Dutch tend to promote, the use of their treaty structure, as a means of investing in various countries including the United States.

Mr. GIBBONS. What is so unique about the Netherlands Antilles? I do not understand the operation.

Mr. BROCKWAY. I am not sure that the Netherlands Antilles is that unique. It is the most favorable of a number of favorable situations. If one were to renegotiate the Netherlands Antilles treaty, which Treasury is in the process of doing—it is under fairly serious discussion at the moment—that still would leave the British Virgin Islands, which in a number of ways are even more favorable.

If you were to restrict those two, there would be others. There are a number of treaties that you have to renegotiate before you totally would restrict practices that are objected to in the Netherlands Antilles.

The other thing that is important about the Antilles is that it is a nontax jurisdiction by and large. You can invest there without having to pay tax in the Netherlands Antilles. We give up our tax on income paid to Netherlands Antilles residents, which almost invariably are not businesses based in the Netherlands Antilles, but are corporations incorporated under the Netherlands Antilles laws which are owned by investors from a third country. These corporations typically have bearer shares, and you don't even know who the actual investors are. We give up our tax on certain income or limit our tax on income that is going from the United States to the Netherlands Antilles, and they in turn may have a very low tax on that income and do not tax it when it is repaid to a third jurisdiction.

Basically it does not help you much to utilize a tax treaty to reduce U.S. taxes if that means just that you are going to pay tax to a foreign jurisdiction, although by and large that is what the treaty purpose should be. The notion of treaties is to avoid double taxation. As I said, by and large we do this through the Code, but there are situations where the rules don't mesh. The principal purpose of the treaties is to make sure that, where there is doubling up of tax liability, it goes to one country or the other. That should result in a transfer of revenue between treasuries in most situations.

Treaty relief should not be provided where it results in no tax whatsoever. The purpose is not to eliminate any tax but it is to allocate the jurisdiction to tax income which otherwise would be taxed by both countries. However, the Netherlands Antilles frequently does impose any significant tax on the income which the United States exempts under the treaty, and that creates the problem.

Mr. GIBBONS. From your observations, how effective or useful is the exchange-of-information provision of these treaties? How effective has it proved to be as far as tax administration is concerned?

Mr. BROCKWAY. I am not sure—I think that is a very good area for some study at some point, perhaps by the GAO. I gather that frequently the information we receive routinely from foreign jurisdictions is supplied in a form that does not readily go into our process here. So we may not make all the use that we might of the information we receive.

Some jurisdictions are more helpful than others in supplying us with that information. With those caveats, I think that the exchange of information provisions are an important aspect of the treaty program.

What we should be striving for in the treaties, I think, is to be willing to modify our tax rules, but to attempt to make sure that the income is reported and that both jurisdictions know about it. A key to this is the exchange of information.

Our most important problem in the international area—this is a personal view—is not so much whether the United States gets the particular revenue or the foreign jurisdiction does, because when we give up jurisdiction to tax certain income, they are reciprocally giving up jurisdiction to tax, so that means the United States is giving up revenue and is getting revenue and there is a wash.

The main problem with respect to international investments is that you have income falling through the cracks. It is fairly easy for someone to avoid taxation in any jurisdiction and that, I think, weakens the overall structure. It makes it difficult to say that you have a fair system and it hurts the system generally. So I think it is very important that we have this exchange of information to insure that income is reported and does not fall through the cracks.

Mr. GIBBONS. You have been working on a report of the Joint Committee on the impact of U.S. income tax treaties on the foreign tax credit. Do you have any idea when that is going to be released to the public?

Mr. BROCKWAY. I would assume fairly soon. We are in draft—I think in your briefing papers you have galleys of it. As it stands, there are some difficulties we have with that document, and we want to resolve those difficulties; also I think the tone of it is a little incorrect. The draft is a little too much concentrated on the language used in the treaties and does not give enough emphasis to the general purpose of the treaties.

Also I think we may have let ourselves go too far down the line of giving what may appear to be legal opinions as to the interpretation of these treaties when evidently there is some disagreement as to what these treaties actually do provide.

Subject to these modifications, we are ready to issue the report. I would say that there is maybe a week or two of work to get the report in a form where we are satisfied with it and the comments of those people whom we have asked to review it have been taken into account.

I don't think we will ever be able to get the report to the point where it won't be controversial. I am afraid that it is an area where people have divergent views as to what the treaties do. We are going to attempt to avoid taking a hard and fast position as to what they provide in this area and we will indicate what the different viewpoints are; but even when we do that, I think, the controversial aspect of it will be that we will say there is a substantial issue with respect to some of the older treaties as to whether they give an independent credit for taxes covered by the treaty.

I think there is a general public viewpoint that the treaties, since they do have a credit article, obviously must give an independent credit for any covered tax. Many of the taxpayers concerned about the proposed regulations, concerned that they are too restrictive, hope the treaty structure will resolve those problems, because they would give an independent credit. It may well be that they do, but the answer is not completely clear for many of the older treaties. I don't think our report will attempt to resolve that issue one way or the other. However, just saying that there is an issue as to whether they give an independent credit will involve some controversy.

Mr. GIBBONS. Thank you, Mr. Brockway.

[The following was subsequently received:]

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., September 4, 1980.

Hon. SAM M. GIBBONS,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. GIBBONS: Following the Oversight Subcommittee's hearings on income tax treaties, you wrote me a letter asking me to provide written answers to several questions regarding the issues presented by the U.S. income tax treaty program. My responses to those questions are set forth in the enclosed memorandum.

Sincerely yours,

DAVID H. BROCKWAY.

Enclosure.

Question 1. What do you think are the major issues and options presented to Congress by the present status of our tax treaty program and the present process used for negotiation and ratification?

A. SCOPE AND OBJECTIVES OF TAX TREATIES

Traditional tax treaty objectives.—The "traditional" stated objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives, modifying the generally applicable statutory rules with provisions which take into account the particular tax system of the treaty country. Given the diversity of tax systems in the world, it would be virtually impossible to develop in the Code rules which unilaterally would achieve these objectives for all countries.

The prevention of tax evasion in this context includes provisions designed to further the administration of the tax laws of each country. The treaties generally provide for the exchange of information between the tax authorities of the two countries where such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

International double taxation refers to situations where the United States and a foreign country both tax the same item of income of a taxpayer (either U.S. or foreign) and neither country allows full relief for the taxes imposed by the other; for example, an item of income received by a resident of one country from sources within the other may be taxed by both. In this context, international double taxation may also be viewed as encompassing "excess" taxation—situations where either country taxes income received by nonresidents at rates which exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross income basis. (Most countries, including the United States, generally tax domestic source income on a gross income basis when it is received by nonresidents who are not engaged in business in the country.) In some cases this occurs because the gross income tax is imposed at a rate which in the typical situation exceeds the tax which would have been paid under the net income tax system applicable to residents. However, it also occurs to some degree even where the gross income tax in the typical situation approximates what would have been paid under that system because there are invariably situations where the expenses of the nonresident associated with the income are sufficiently high that the tax imposed exceeds the tax imposed on a comparably situated resident taxpayer.

Another traditional objective of U.S. tax treaties which fits within the rubric of the avoidance of double taxation (giving it a broad interpretation) is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction where the contacts with, and income derived from, that jurisdiction are minimal. This is generally accomplished by exempting residents and companies of one country from taxation by the other unless the taxpayer's activities or contacts with the source country exceed certain minimums specified in the treaty. For the most part, the various rate reductions and exemptions provided in treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents.

Most treaty provisions are directed toward relieving any such double taxation and preventing tax evasion (both as broadly construed above). There are, however, a variety of different provisions in various U.S. tax treaties which are significantly more far-reaching than would be necessary to achieve these objectives or which are intended to further other objectives. One of the most important issues in evaluating the U.S. treaty program is whether the scope of U.S. tax treaties should be limited to the avoidance of double taxation and the prevention of tax evasion—that is, whether, and under what circumstances, U.S. tax treaties should attempt to accomplish objectives unrelated to the avoidance of double taxation and the prevention of fiscal evasion and whether, and under what circumstances, U.S. tax treaties should operate as a practical matter to reduce aggregate tax burdens on affected income below the levels necessary to avoid double taxation.

While in most cases the appropriate means for meshing the U.S. tax system with foreign tax systems are fairly standard from one foreign country to another, a limited number of unique problems usually come up with respect to each country as the result of particular aspects of their tax system or treaty objectives of that country. Those arguing for a broader scope for tax treaties argue that in many cases these problems are appropriate for resolution in a bilateral tax treaty—either because the resolution of the matter is in its own right beneficial to U.S. interests or because the resolution of the matter on terms acceptable to the treaty partner is necessary in order to obtain other concessions valuable to U.S. interests. Tax treaties are negotiated agreements requiring concessions by each side. It is argued that the United States, if it is to have a viable tax treaty program, cannot apply any set of objectives dogmatically but instead must be flexible and assess the finally negotiated package on its overall merits. Moreover, as separately discussed below, there are those that argue that tax treaties should have additional general purposes such as the encouragement of U.S. investment abroad or foreign investment in the United States through tax incentives (reductions in tax on the transnational investments in question below the levels necessary to prevent double taxation) authorized by or granted in the treaty.

A practical argument for restricting the scope of tax treaties is that the more proposed treaty provisions depart from traditional treaty provisions, the more likely they are to involve controversy delaying, or possibly preventing, Senate approval with all the attendant problems (consider, for example, the controversy surrounding the state taxation article (Article 9(4)) of the proposed U.K. treaty). Moreover, as discussed under the following heading, there is a strong feeling in Congress that treaties should not include new provisions which are not consistent with the policies reflected in the Code and that if new policies are to be set in this area, they should be set through the regular legislative process where they can be fully debated and analyzed, shaped as appropriate in response to the issues raised in the legislative process, and adopted on their own merits rather than as a quid pro quo for some other provision.

Impact on tax policy set through domestic legislation.—Tax treaties, in implementing their objectives, necessarily change domestic tax rules. To a certain extent, they also set tax policies which are not reflected in the Code. This raises issues as to the method of approving tax treaties (e.g., whether tax treaties should not be self-executory in form) which are separately discussed below. It also leads many observers to urge that the scope of tax treaties be restricted. (See, for example, the attached statement of Mr. Vanik and the attached Senate floor colloquy.)

There is a view that the broader the scope of tax treaties, the more likely they are to "usurp" the traditional tax legislative prerogatives of the Congress. While Congress does participate in the tax treaty process, through the approval by a two-thirds majority of the Senate to the ratification of the treaty, as a practical matter the involvement of the Congress (particularly the House of Representatives and the tax-writing committees of both the House and the Senate) and the public is much more limited than in the case of tax legislation, and the control of the Executive branch (and the Treasury in particular) is significantly greater. Tax legislation must originate in the House of Representatives, frequently is initiated by the Congress, and can readily be modified by the Congress both during the process of enactment and thereafter. Tax treaties on the other hand are initiated by the Executive branch with very little Congressional input and must be considered by the Congress on a basically take it or leave it basis—any change by the Congress in the overall package during the ratification process might result in the failure of the treaty to be ratified by the treaty partner and thus presents very substantial problems. The problems facing the Congress when it wishes to modify the provisions of an existing treaty are even greater since, although it has the power to do so, unilaterally overriding a tax treaty obligation with domestic legislation is thought by many to be a course which should be avoided wherever possible.

Expansion of treaty network.—Historically, the U.S. treaty network has largely been confined to the other industrialized countries with which the United States has significant trade and investment ties. In recent years, tax treaties have been negotiated with a number of countries with which the U.S. trade and investment ties are relatively minor.

An issue to be considered is how aggressively the United States should pursue an expanded tax treaty network. On the one hand, there are several countries with which the United States does not have tax treaties but which are not insignificant from a trade or investment standpoint. Also, even where U.S. trade and investment interests are tangential, some observers feel that a tax treaty relationship is advantageous. In contrast, other observers question whether the devotion of resources of the Treasury and Congress required by the expansion of the treaty network is justified by the benefits. They point out, moreover, that an expanded treaty network expands the potentials for abuse (especially since many of the prospective treaty partners do not have particularly sophisticated tax systems or administrations).

Source basis versus residency basis taxation.—Over the years, U.S. tax treaty negotiators have been very strongly oriented toward residency basis taxation. They have generally sought treaty articles providing, particularly with respect to periodic income such as dividends, interest, royalties, etc., that where a resident or company of the United States derives income from the treaty country, that country is to cede to the United States the jurisdiction to tax the income and, in exchange, the United States is to cede jurisdiction to tax U.S. source income of the treaty partner's residents and companies. This policy is also followed in the OECD model treaty and by almost all other industrialized countries in their bilateral tax treaties. Many of the situations where the U.S. tax policy established in the Code is changed through the treaty program are attributable to this pursuit in the treaties of residency basis taxation. The appropriateness of this treaty orientation in light of current circumstances is one of the major issues presented by the U.S. treaty program.

One policy consideration underlying this U.S. negotiating position is that the surest way to eliminate any possible instance of double taxation is to limit the jurisdiction to tax to one country. Even where mechanisms such as the foreign tax credit operate to eliminate any possible double taxation, limitation of the jurisdiction to tax to one country can substantially reduce complexity and compliance burdens in some cases. The country of residence has the advantage of being the country which is in the best position to take into account the expenses, wherever incurred, of generating the income. Allocation of expenses is at best an arbitrary approximation and some of the most difficult double taxation issues arise because of conflicts between the system used by the country of source and the country of residence for allocating expenses incurred outside the country of source. Moreover, only the country of residence is able, as a practical matter, to tax income on a graduated rate basis. The theory of graduated rate structures is that the rate of tax should be based on the ability to pay; this is a concept that makes sense only with respect to a taxpayer's worldwide income. (If jurisdiction to tax were limited to the country of source, a taxpayer could reduce his overall rate by splitting his income among several countries.) In order for the source country to apply a graduated rate structure accurately, it would have to employ an exemption with progression system computed with reference to the nonresident's worldwide income—an extreme administrative and compliance burden if that were the international norm for taxing nonresidents and foreign corporations.

On a more pragmatic level, one of the most important reasons U.S. treaty negotiators have tilted toward residency basis taxation has been their perception that reciprocal rate reductions and exemptions tend to be revenue raisers for the U.S. Treasury. Historically, the United States has been a net capital exporting country (i.e., U.S. residents and corporations generally earn more income from sources within our treaty partners than their residents and corporations earn from U.S. sources). The argument is that a net benefit accrues to the U.S. Treasury because the loss in U.S. tax revenues resulting from the U.S. tax rate reductions and exemptions for U.S. source income for their residents and corporations will be exceeded by the increased U.S. tax on U.S. taxpayers receiving income from the treaty countries which is attributable to reductions of their foreign tax credits as a result of the reduced foreign tax.

There is, however, substantial question as to whether such reciprocal rate reductions and exemptions do in fact result in a net revenue gain to the U.S. Treasury. The reduction of U.S. tax on nonresident aliens and foreign corporations clearly results in a revenue loss to the U.S. Treasury. In contrast, however, the fact that a taxpayer's creditable foreign taxes are reduced does not necessarily mean that its after-credit U.S. tax is increased. This is particularly true since the adoption of the overall foreign tax credit limitation in 1960 and the reduction in U.S. corporate tax rates below those generally applicable in other countries. There are indications that many U.S. multinationals are in an excess foreign tax credit position (i.e., their creditable foreign taxes exceed their foreign tax credit limitations) or would be in an excess credit position but for the reductions in their foreign tax liabilities pursuant to U.S. tax treaties. Therefore, to the extent that the treaty reductions in foreign taxes merely operates to eliminate otherwise unusable excess foreign tax credits, the benefit accrues to the taxpayers, not to the Treasury (not necessarily an unwarranted result, but one that indicates that reciprocal reductions and exemptions do not necessarily result in a net benefit to the Treasury). Moreover, one reason that U.S. multinationals may find themselves at their foreign tax credit limitation is their ability to manage their credit situation by repatriating earnings from their low-taxed foreign subsidiaries only to the extent that the earnings repatriated from their high-taxed foreign operations generate excess credits to shelter the low-taxed income. Where a taxpayer can successfully employ such a repatriation policy, a reduction of foreign taxes pursuant to a treaty will reduce its creditable foreign taxes with the result that it will repatriate less from its low-taxed subsidiary. Thus, the treaties reduce its foreign tax burden but do not yield an offsetting U.S. tax increase—the net effect is merely to increase the amount of low-taxed earnings it can profitably defer overseas.

An independent argument advanced for reexamining our present treaty bias toward residency basis taxation is that it facilitates tax avoidance and evasion. The only truly effective means of controlling tax avoidance and evasion is through withholding at source. To the extent that source basis taxation is restricted, it serves to increase the flow of movable capital to tax havens and tax secrecy jurisdictions with the result that little or no tax is paid on the income to any country. This clearly is the case where the treaty partner does not impose any significant tax on U.S. source income (a situation which may be more likely to occur as the United States expands its treaty network beyond the other industrialized countries which until recently had comprised the large majority of the U.S. treaty partners). However, restrictions on taxation at source may also effectively result in the avoidance of significant taxes worldwide even where the treaty partner in theory taxes its residents on U.S. source income.

For example, an investment into the United States can be made through an entity established in a treaty country which in turn is controlled by an entity in a haven. If the treaty country entity can pay most of its U.S. source income to the haven entity in the form of interest or other deductible payment and if the treaty country does not impose any significant withholding tax on the payments to the haven entity, the U.S. source income can be routed to the haven with little or no tax imposed. (This assumes that the U.S. "second withholding tax" is not applicable to the payments by the treaty entity or has been waived in the treaty.) Consequently, the residency basis taxation policy of the treaties places the United States in the position of relying on our treaty partners to prevent abuse of our tax system—a particularly risky proposition in the case of treaties with tax havens or countries such as the Netherlands which promote the use of their treaty networks as conduits for transnational investments since they have little to gain and something to lose by discouraging such abuses.

Tax incentives for foreign investment in the United States.—As noted above, most tax treaty provisions involve rate reductions or exemptions by the country of source on the assumption that the country of residence will tax the income at rates comparable to the rates generally applicable in the source country. Such reciprocal rate reductions and exemptions operate to eliminate double taxation (including excess taxation) and, in certain situations, the burden of complying with the tax regimes of several jurisdictions with respect to the same operations. As a general rule, however, they do not create an incentive to invest in the source country (as contrasted with the elimination of barriers facing foreign investors not faced by domestic investors) as long as the residency country taxes the income at rates at least as high as those imposed by the source country on domestic investors. (Under the U.S. overall foreign tax credit system, reduction of rates of tax in a country below the U.S. rate can operate as an incentive for a U.S. investor with excess credits arising in another country.)

There are a number of situations, primarily, but by no means exclusively, ones involving tax treaties with tax havens such as the Netherlands Antilles and the British Virgin Islands, where foreign investors can derive income from the United States which is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a U.S. tax treaty without being effectively subject to tax abroad at rates comparable to the U.S. rates. In practice, these situations have generally been exploited by investors from any foreign country, not just investors from the treaty country, merely by investing in the United States through a corporation or other entity established in the treaty country. (See the discussion of treaty shopping below.)

Notwithstanding the competitive advantage provided foreign investors over U.S. investors in these situations, many observers contend that these windows into the United States are necessary to encourage foreign investment which would otherwise be discouraged by our statutory tax rates. Whether foreign investment in the United States should be encouraged by reducing or eliminating the tax on U.S. source income received by foreign investors is a frequently debated issue and a very important tax policy issue, but it is too complex to be analyzed here. (For a more detailed discussion of some of the issues involved, see the Joint Committee on Taxation pamphlet on the Exemption from U.S. Tax for Interest Paid to Foreign Investors (JCS-29-80).) Passing that question, however, there is also the issue of whether it is appropriate to adopt as a treaty policy the encouragement of foreign investment in the United States with tax incentives not available to U.S. investors where that policy has not been adopted, and in certain important respects has specifically been rejected, by the Congress as a matter of legislative tax policy.

Treaty shopping.—One of the most important issues of U.S. tax treaty policy is the extent to which, if any, the tax benefits extended by the United States in its bilateral income tax treaties should be denied to corporations or other entities established in the treaty country but which are directly or indirectly owned in substantial part by residents of third countries or residents of the United States. As a general rule, third-country residents (and first-country—i.e., U.S.[1]—residents) can obtain the benefits of the U.S. rate reductions and exemptions provided in a bilateral U.S. tax treaty by establishing in the treaty country a corporation or other entity through which the U.S. investment is routed. Consequently, investors from any country wishing to invest in the United States have the option of routing the investment through any country with a tax treaty with the United States and thus can select the option involving the lowest aggregate (U.S. and foreign) tax. This is ordinarily referred to as "treaty shopping." A common example of this is the practice of foreign investors from many different countries to hold U.S. real estate through Netherlands Antilles corporations entitled to claim the benefits of the U.S.-Netherlands Antilles treaty.

Article 16 of the U.S. model income tax treaty is designed to block treaty shopping in limited cases. It denies treaty benefits to investment companies with respect to interest, dividends, and royalties received from the United States where that income is subject to special favorable tax treatment by the treaty partner and the investment company is at least 25 percent owned, directly or indirectly, by individuals not resident in the treaty country. Seven U.S. tax treaties presently contain anti-treaty shopping abuses analogous to Article 16 of the U.S. model, and it is the Treasury's present negotiating policy to include such a provision in all U.S. income tax treaties.

When the United States enters into a bilateral tax treaty with a jurisdiction which does not impose any significant tax on income of third-country residents who would use entities established in that country as conduits to invest in the United States, the rate reductions and exemptions from U.S. tax are, as a practical matter, available to all nonresident aliens and foreign corporations, regardless of the country in which they are based, and not just those based in the treaty country. As a consequence, the effect of such treaties at times approaches that of generally applicable legislation modifying or repealing the Code provisions affected by the treaty. These treaties do not have the impact of making the Code provisions complete dead letters because tax considerations are frequently not a primary factor to the foreign investor (particularly where any U.S. tax paid is allowed as a foreign tax credit by its home country) and the cost of routing the investment through the treaty country may not be justified by the tax savings.

A principal argument made in favor of the present situation is that these rate reductions and exemptions are appropriate and necessary to attract foreign investment to the United States. (As discussed above, the issue of whether tax incentives should be adopted to encourage such investment is complex and controversial.) If, as a matter of policy, Congress determines that tax incentives for foreign investment in the United States would not be appropriate, it would seem to follow that additional limitations should be placed on treaty shopping. Even if tax incentives for foreign investment are thought to be advisable, Congress might nevertheless consider limitations on treaty shopping to be appropriate on the grounds that a policy of providing such incentives should not be established and carried out as a by-product of tax treaties with tax havens such as the Netherlands Antilles and the British Virgin Islands but rather it should be formulated and adopted by the Congress through the regular legislative process. By implementing what is essentially an internal tax policy matter through the allowance of tax haven treaty shopping, the United States gives up a considerable degree of flexibility to modify that policy by making it an international obligation. The policy so implemented, by being available as a practical matter to residents of all foreign countries, not just the treaty partner, has no particular nexus with the foreign country; it has nothing to do with meshing the two tax systems or facilitating or encouraging investment or trade to or from (as opposed to through) the treaty partner.

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[1] In many situations, no significant benefit from the use of the U.S. treaty network would accrue to foreign corporations controlled by U.S. shareholders because of the subpart F rules and the foreign personal holding company rules of the Code.

One possible response of the United States to treaty shopping would be to limit the U.S. rate reductions and exemptions provided in a tax treaty only to those entities which can establish that they are substantially owned by residents of the treaty country or by residents of other countries having treaties with the United States providing equivalent benefits. Alternatively, treaty shopping could be permitted to continue in those situations where it is considered to be "legitimate." A subsidiary issue is whether, if any such anti-treaty shopping limitations on the use of U.S. tax treaties are appropriate, they might appropriately be imposed by Congress through legislation or whether such a policy should only be adopted and implemented through the tax treaty process.

Tax havens.—Questions have been raised as to whether it is advisable for the United States to enter into, or continue in force, tax treaties with tax havens. In general, tax havens are small countries which permit foreign investors to accumulate income without any significant tax burden. In addition, tax havens frequently have secrecy laws protecting the identity of foreign depositors in bank accounts, beneficiaries of trusts, ultimate corporate ownership, etc., which enable foreign investors to evade the tax, currency, and criminal laws of the United States and other countries. The havens generally act as conduits for investments by foreign individuals and corporations and seldom are the source or the ultimate destination of the investments routed through them.

Certain havens are covered by U.S. treaties because of their status as territories of other nations with which the United States has treaties. It was through this mechanism that the Netherlands Antilles and the British Virgin Islands, now both well recognized havens, came to be covered. It is not clear that the full consequences of these territorial extensions were fully appreciated at the time.

The Treasury announced last year that it was reviewing the desirability of continuing the extensions with respect to the Netherlands and U.K. treaties. At the same time, however, the Treasury has given increased emphasis to the conclusion of treaties with developing countries. Some of these countries may, now or in the future, prove to be tax havens. An example is the proposed income tax treaty with Cyprus presently pending in the Senate Foreign Relations Committee.

The entire question of the type of treaties which should be maintained with havens is worthy of Congressional review. With respect to those types of income which are not subject to any significant tax by the haven, the double taxation which the treaties are intended to deal with clearly does not exist. Since the basic goal of havens is to provide an attractive climate for investors wishing to avoid or evade the higher taxes and other laws of other countries, it is seldom in their interest to work to prevent fiscal evasion by exchanging information (or to obtain useful information with respect to the foreign investors which might be available for exchange). A legitimate question can be raised whether it is in the national interest to contribute to the viability of tax havens by entering into tax treaties with them.

One factor which should be taken into account in examining this issue is that allegations have been made that drug money and other profits arising out of criminal activities may be laundered by being sent abroad and recycled into the United States through entities established in tax havens having tax treaties with the United States. The initial haven entity may well be established in a tax haven without a U.S. tax treaty but with extremely strict secrecy laws (e.g., Lichtenstein, the Cayman Islands, or the Bahamas). This tandem operation would not seem to be absolutely necessary, since the tax havens having treaties with the United States permit corporations to issue bearer shares with the result that the identity of the shareholders is protected from the U.S. authorities. However, discretion appears to be appreciated in this sphere. The original entity is most likely to route the funds into the United States through an entity established in a tax haven with a U.S. tax treaty, since the income on the U.S. investment will benefit from the applicable U.S. rate reductions and exemptions, and the income can be routed through the treaty haven to the original entity with little additional tax imposed by the treaty haven. The investment could be routed through a non-haven U.S. treaty partner, instead of a tax haven, but that might result in some additional tax by the non-haven country as the income passed through to the original investing entity.

Tax incentives for investment abroad ("tax sparing").—A long-standing issue of U.S. tax treaty policy is whether there are any circumstances in which U.S. tax treaties should provide special incentives for investment abroad. Generally, this issue is discussed in terms of the advisability of providing for "tax sparing"—a term ordinarily used to describe the allowance of a foreign tax credit for amounts which would have been paid as taxes to the foreign country but which are forgiven by the foreign country pursuant to a tax holiday program designed to attract investment. (In effect, this is the manner in which the United States taxes business operations in Puerto Rico under section 936 of the Code.) A number of foreign countries provide for tax sparing in tax treaties with certain other countries (generally less developed countries) having tax holiday programs. During the 1950s and 1960s, several tax treaties were negotiated by the Treasury with developing countries which contained tax sparing on a limited scale (e.g., India) or which would have provided an investment tax credit for investments by U.S. companies in the treaty country (e.g., Brazil). The Senate refused, however, to give its advice and consent to the ratification of those treaties unless the tax sparing or investment credit provisions were deleted. Since that time, explicit tax incentives for investment abroad have not been contained in U.S. tax treaties.[3]

Certain developing countries wishing to attract U.S. investment through tax incentive programs and certain business interests have argued that the United States should reconsider its policy of not agreeing in its tax treaties to incentives for investment abroad. There is little investment in the United States which originates from these countries, and these countries generally do not desire treaty provisions making such investment attractive because they do not want the investment diverted from their economies. Accordingly, they generally see provisions which would encourage U.S. investment in their countries as the principal attractions of a tax treaty with the United States. Since the United States refuses to concede on this issue, many of these countries have refused to enter into tax treaties with the United States. Those business interests urging that the U.S. position on tax sparing be reconsidered argue that the other benefits accruing to U.S. interests under treaties with these countries would justify a concession on this point. It is also argued that U.S. businesses investing in these countries are placed at a disadvantage as compared with their competitors from other industrialized countries which do have tax sparing treaties with these countries.

The principal argument against tax sparing or other tax incentives in treaties is that it would treat investment abroad more favorably than investment in the United States, diverting investment abroad to compete with U.S.-based industry and labor. It is also argued that, over the long run, tax holidays and tax sparing provisions designed to accommodate them operate to help neither country; they merely serve to stimulate tax competition among developing countries in order to attract investment from other countries—in the end not increasing the aggregate amount of investment but undermining the revenue bases of all. Also, it is argued that if we maintain our present policy, many of these countries will enter into tax treaties with the United States in any event (e.g., Pakistan, Korea, Jamaica, and Argentina).

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[3] The proposed income tax treaties with Israel and Morocco would provide for a foreign tax credit for certain forced loans mandated by those countries. While these provisions could be analyzed as investment incentive provisions, their apparent rationale is that the forced loan payments are analogous to income tax payments and thus should be creditable.

A more general argument against including tax incentive provisions in treaties goes to the issue of how such a policy should be decided and who should decide it rather than to the merits of whether tax incentives for investments abroad would be good policy for the United States. Tax sparing incentives designed to encourage U.S. investment abroad would not be in furtherance of, but would be contrary to, the general tax policies established by Congress in the Internal Revenue Code. It can be argued that Congress is the appropriate body to establish and change U.S. tax policy and that if a change in U.S. tax policy as significant as favoring foreign investment over U.S. investment is to be made, it should be made through, or authorized by, legislation adopted by Congress.

Foreign tax credit.—Most recent U.S. income tax treaties provide expressly that certain taxes imposed by the treaty partner will be treated as creditable income taxes for purposes of the U.S. foreign tax credit. Where, as generally is the case, these declarations are made with respect to foreign taxes which the Treasury considers to be creditable income taxes under the Code in any event, the treaty provisions do not provide any additional rights in this regard but they are useful in that they do provide certainty to taxpayers as to the creditability of the foreign taxes in question. This goal cannot, however, be viewed as being particularly significant since such certainty can easily be provided through revenue rulings without committing the United States to the treaty partner. By the same token, little, if anything, is lost by making such a commitment in the treaty where the United States would grant the credit regardless. Consequently, there does not appear to be any controversy as to whether an independent credit should be provided in U.S. tax treaties for foreign taxes which would be creditable under the Code.

A more significant issue arises where an independent treaty credit is provided for a foreign tax which may not qualify as a creditable income tax or in lieu of tax under the Code. Where the question as to the creditability of the foreign tax arises out of some technical requirement of the U.S. foreign tax credit rules and the economic substance of the foreign tax in question is such that the allowance of a credit for the tax would be in furtherance of the objectives of the statutory foreign tax credit provisions, the controversy as to the appropriateness of providing an independent treaty credit would again appear to be minimal. An issue does arise, however, as to why the appropriate response is not also to amend the Code to eliminate or modify the presumably misguided technical requirement of U.S. law which created the unwarranted questions as to the creditability of the foreign tax.

The significant treaty policy issue involving the foreign tax credit is whether an independent treaty credit should be provided for payments to foreign governments which do not (at least in the opinion of the Internal Revenue Service) satisfy the statutory requirements for creditability.[3] Credits for payments to foreign governments which would not qualify for the statutory foreign tax credit are defended on the grounds that such concessions are valuable bargaining chips which can be used to secure concessions by the treaty partner, that such credits are necessary to encourage U.S. investment in the foreign country as a matter of foreign policy or energy policy, or that, because of the strictness of the Code creditability standard, flexibility should be allowed in the treaty process for credits on a country-by-country basis where Treasury concludes that failure to allow a credit for the particular foreign tax would in substance, if not in the most strict technical sense, result in double taxation or otherwise put U.S. businesses operating in the treaty country at a competitive disadvantage.

However, other observers argue that if, as a matter of policy, Treasury does not believe a credit should be allowed for a certain type of tax regardless of the country imposing the tax (i.e., where it does not believe our present statutory rules should be amended to allow a credit for that type of tax), then an independent credit generally should not be provided for the tax by treaty. Moreover, some observers argue that where Treasury does not view present law as providing for a credit for a particular type of tax, the appropriate means of modifying the law is through legislation so the change applies for taxes of that type regardless of the country imposing the tax. It is also argued that, if as a matter of policy apart from any possible concessions by the treaty partner a credit should not be given for the particular type of payment, then it is doubtful that any concession can be received in exchange for granting the credit. It is also argued that granting such credits violates the integrity of the U.S. system. Finally, it would be naive to ignore the fact that an extensive but selective program of guaranteeing credits for foreign taxes through treaties without regard to the Code rules would have a significant impact on the outcome of the current debate as to the requirements for creditability under the Code. Concern has been expressed by some in the petroleum industry that such a program not be used to isolate them in this debate.

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[3] The proposed foreign tax credit for forced loans to Israel and Morocco provided for in the pending treaties with those countries are the clearest examples of payments which would not qualify for a credit under the Code requirements but which would be creditable under a treaty. Under the Code, neither a credit nor a deduction would be allowed with respect to the forced loans; they are assets of value (evidently, the expectation is that they will be repaid) which taxpayers are required to hold as a condition of doing business in the countries. The issue is whether, in the case of taxpayers who are not in an excess credit position (the credit is of no benefit where the taxpayer is in an excess credit position), the U.S. Treasury should bear the burden of the forced loans to Israel and Morocco so that the taxpayer can carry on its business activities there or whether the taxpayer should bear that burden.

In any event, in those cases where an absolute foreign tax credit is granted in a bilateral treaty which is not subject to the Code requirements that the payment be an income tax or a tax in lieu of a general income tax (Code Secs. 901 and 903), a separate issue arises whether that treaty credit (without limitation of the statutory credit is applicable) should be subject to a per-country limitation so that the treaty credit cannot be used to offset U.S. tax on income arising from sources outside of the treaty partner.

B. RELATIONSHIP BETWEEN THE CODE AND THE TREATIES

Conflicts between Code and treaty provisions.—The present rules governing the resolution of conflicts between tax treaties and the Code are in need of revision. Under the Constitution, treaties and legislation are on an equal footing and, in the case of a conflict between the two, the later in time controls. The Code has two rules which significantly reduce the situations where amendments to the Code will override inconsistent treaty obligations. Section 7852(d) seems to provide that amendments to the Code will not apply to the extent they are inconsistent with treaty obligations in existence on the effective date of the 1954 Code. Section 894(a) provides that no Code provision will operate to deny any exemption from gross income provided for in any tax treaty, whether or not in existence prior to the 1954 Code.

At a minimum, it would appear advisable to replace sections 894(a) and 7852(d) with a single provision governing conflicts bewteen the Code and all treaties, not just those predating the 1954 Code, and all conflicts, not just those involving exemptions from gross income. In adopting any such rule, some account should be taken of situations which have arisen several times in recent years in which Congress has amended the Code only to find after the legislation has passed that the new Code provision arguably conflicted with existing treaty obligations. Had the possible treaty conflict been recognized the time the legislation was being considered, that Congress might have dealt with it by allowing the existing treaty provision to control, by providing for the new Code rule to prevail (possibly with a delayed effective date intended to allow time for renegotiation of the treaty provision), or by some other action.

One possible rule which might be adopted to deal with these situations would be to provide generally that where an amendment to the Code conflicts with an existing treaty obligation, the effective date of the Code amendment will, to the extent of the conflict, be delayed for a period of, say, 5 years to allow time for renegotiation; after that period, the Code amendment would be fully effective notwithstanding any contrary treaty provisions remaining in effect. Where a result different than that general rule was desired, it could be so provided in the legislation modifying the Code. Also, where the possible conflict only becomes apparent after the legislation is enacted, the delayed effective date would allow time to reconsider, in light of the conflict, whether the particular Code amendment was desirable.

Even with delayed effective dates, many observers feel that it is a very bad idea for the United States to abrogate its treaty obligations unilaterally. They argue that if the United States wants to change its tax policies in a way which would conflict with an existing treaty obligation, the conflict should only be resolved through renegotiation of the treaty. Such a stance, however, clearly gives great advantage to those benefiting from the treaty provision to delay or prevent the renegotiation of the treaty in accordance with Congressional policy objectives. The more tax treaties the United States has, and the more far-reaching the provisions in those treaties, the more likely it is that situations will arise where Congress will wish to adopt policies which will conflict with those reflected in the treaty network and the less likely it will be that those policies can be effectively implemented in any reasonably short period through renegotiation of all the treaties involved. That being the case, a policy of against unilaterally overriding treaties even with a delayed effective date would leave Congress with little room in which to maneuver. One way in which both sets of concerns might possibly be accommodated would be to recognize in the treaties the possibility that either country might subsequently wish to adopt tax legislation which conflicted with the treaty provisions and to provide in the treaty some mechanism designed to resolve the conflict. For example, the treaty could provide that either country could amend its tax laws to include provisions inconsistent with the treaty provided the conflicting provisions did not go into effect for a period of, say, 5 years after notice of the amendment was given to the other country. This would permit such changes without a breach of international obligations.

Coordination of Code and treaty principles.—Many of the principles of U.S. treaties (e.g., taxing business profits of a foreign enterprise only to the extent "attributable to a permanent establishment") are consistent with international norms for tax treaties as reflected, for example, in the OECD model. In general, these principles are analogous to, but in a variety of situations somewhat different than, the standards employed in the Code (e.g., taxing foreign businesses on their profits only to the extent they are "effectively connected with a U.S. trade or business"). Given the fact that most foreign investment between the United States and other countries is with or through countries with which the United States has tax treaties, questions have been raised as to whether it might be worthwhile to bring the Code rules more closely into line with the international norms reflected in the treaties. It would not be practical to attempt to conform our tax treaties with the Code standards since they are not widely employed by other countries.

The lack of conformity between the Code and treaty structures raises a variety of problems. Even where the policy objectives of the Code and the treaty standards are substantially the same, the use of differing concepts and terminology can create confusion and other difficulties in meshing the two systems. (It is, for example, entirely possible for certain aspects of the taxation of a particular operation to be governed by Code standards and other aspects by treaty standards.) To illustrate, it is generally accepted that the Code trade or business standard is somewhat broader than the treaty permanent establishment standard (that is, income might be effectively connected with a U.S. trade or business without being attributable to a U.S. permanent establishment), but it is not at all clear which situations would be covered by one standard but not the other. Those Code rules which turn on whether an item of income is effectively connected with a U.S. trade or business generally do so because it is relevant to the particular rule that the income is subject to the regular U.S. income tax. This is not, however, necessarily the case if a treaty applies to limit the U.S. taxing jurisdiction to U.S. permanent establishments. To the extent such possible mismatches are viewed as problems, they could be eliminated by providing, when a Code concept (e.g., effectively connected with a trade or business) is supplanted by a treaty analog (attributable to a permanent establishment), for the treaty analog (as defined in the particular treaty in question) to be applied for Code purposes generally where the supplanted concept is used. Alternatively, coordinating the two systems could be eased to some degree by adopting in the Code the treaty concepts and terminology, and modifying them to the extent necessary to carry out the Code policies. This might at least lead to the development of a relatively uniform body of U.S. law (including regulations) interpreting the rules in this area for use as a benchmark (to be contrasted with the present situation where regulations interpreting the treaty provisions are no longer issued and Treasury, at least, takes the position that provisions of substantially identical wording in two different U.S. tax treaties can have different meanings).

The impact of having two different systems operating in the same area is magnified by the elective nature of treaty rules. (All U.S. tax treaties provide that the treaty rules are not to be applied where the Code rules would be more favorable to the taxpayer.) The source rules provide a good example of a situation where the mismatch between the two systems can have a significant impact. Source rules by their very nature are arbitrary, but any reasonable rules should produce sensible results over the long haul if (but only if) they are consistently applied. Treaties frequently provide source of income rules which depart in certain respects (depending upon the treaty) from the U.S. source rules. In situations where the Code rules would treat an item of income as sourced within the foreign country but where the foreign country agrees in the treaty to yield its jurisdiction to tax U.S. residents on the item in exchange for a reciprocal concession by the United States, it may be possible for a U.S. taxpayer to claim the treaty exemption from the foreign country but apply the Code rule in computing its U.S. foreign tax credit limitation—in effect getting the best of both worlds.

As a separate point that might fit within the general topic of harmonizing the Code and treaty rules, it has been suggested that the U.S. withholding taxes applicable to foreign investors are unreasonably high. While it is doubtful that the U.S. withholding rates should be reduced to levels comparable to those generally provided for in treaties, some changes in the present rules might be appropriate.

C. ADMINISTRATIVE ISSUES

Competent authority.—The Internal Revenue Service has considerable latitude under the competent authority provisions of the treaties to compromise, in order to avoid double taxation, tax liabilities which otherwise would be asserted. This is particularly true in the area of income reallocation (Sec. 482). Questions have been raised as to the standards used in applying this discretionary authority to yield U.S. tax otherwise due under the Code. A separate issue from whether the standards used are appropriate is whether those standards should be publicly articulated and open to scrutiny.

An issue also exists as to whether the rules relating to the disclosure of tax return information exchanged pursuant to the treaties should be modified to permit the General Accounting Office access. It is the position of the IRS that information it receives pursuant to the exchange of information provisions can not be inspected by the GAO in the course of an audit of the IRS's administration of its competent authority functions because the treaties limit the access to such information to those (including courts and administrative bodies) involved in the administration and enforcement of the tax laws. (The one exception is the present treaty with Canada which does not have such limitations on disclosure of exchanged information.) It is the view of the GAO that, without such access, it cannot effectively audit the IRS's conduct in performing its competent authority and exchange of information functions.

As a separate issue, there has been some debate as to whether the competent authority provisions should be broadened to permit administrative resolution of instances of double taxation which are beyond the scope of the treaty in question. Although they are seldom followed on this point in bilateral treaties, both the OECD model income tax treaty and the U.S. model provide that the competent authorities of each treaty country may consult together for the elimination of double taxation arising out of matters beyond the scope of the treaty. In the case of the United States, this provision has only been included in the recent treaties with Poland and Hungary and the proposed treaties with Cyprus, Jamaica, and Malta. It appears that the intention is that the competent authorities should do more than consult; possibly the intention is that they should be free, in those situations they deem appropriate, to agree on adjustments to tax liability which are not provided for in the treaty. Treasury representatives have urged such broad powers on behalf of the administraters, arguing that tax treaties should be living documents flexible enough to deal with double taxation arising out of changes in circumstances arising after they are ratified or situations which were not contemplated during the negotiations but which fit within the broad purposes of the treaties. Opponents of such broad powers for the competent authority argue that no such open-ended delegation of legislative power to the IRS and the Treasury is appropriate.

Exchange of information.—The ability to obtain exchange of information agreements is frequently cited as an important justification of the U.S. tax treaty program. Questions have been raised, however, as to the effectiveness of the exchange of information under existing treaties. A study, possibly by the GAO, of effectiveness of the exchange of information provisions and their administration by the IRS might be useful to identifying the situations in which these provisions have had a meaningful impact and the changes, if any, in the provisions or their administration which might be beneficial.

As a separate issue, a number of commentators have urged that the United States attempt to secure limited scope treaties with countries not presently U.S.

treaty partners (particularly countries in the Caribbean and Latin America) dealing with little or nothing more than the exchange of information and assistance in collection. The notion is that since many of these countries see little advantage—and frequently significant disadvantage—in entering into a tax treaty with the United States involving the typical reciprocal rate reduction and exemptions, possibly they could be persuaded to enter into short form treaties intended to assist each country in enforcing its taxes but which would not involve any revenue loss for the foreign country or create an outflow of investment capital to the United States. There is considerable doubt whether many of these countries would be interested in such arrangements, but then, with one possible exception, there does not appear to be any great harm in trying. The one exception to bear in mind in connection with any exchange of information provision is that it is a two way street and consideration must be given to the extent to which it is advisable to provide sensitive tax information to other governments and what safeguards should be imposed.

Withholding mechanisms.—Concern has been expressed that the U.S. tax rate reductions and exemptions provided in U.S. tax treaties have been availed of to a possibly significant degree by third country residents not entitled to treaty benefits but who have their U.S. source income paid to a nominee or address located in a treaty country. It is very difficult under the procedures presently employed for the IRS to determine with certainty whether income qualifies for a U.S. rate reduction or exemption pursuant to a treaty. The information obtainable under the exchange of information provisions in many cases is inadequate for this purpose, and the IRS has no subpoena power abroad to compel production of the information necessary to establish the beneficial owner of the income. Because of its limited ability to obtain and inspect the necessary records, the IRS in large part relies on the representations of the foreign payee.

In view of these enforcement problems, the IRS might consider changing the procedures used to determine if a U.S. rate reduction or exemption is appropriate by requiring some form of certification that the recipient of the income is reporting it to his country of residence. Alternatively, the procedures could be changed to provide for continued withholding at the source at the full rate but for reduction or elimination of the recipient's underlying tax liability. The burden would then be on the recipient to file a return claiming a refund of the withheld tax, and to establish his entitlement to the treaty benefits.

D. PROCEDURAL ISSUES

Role of Congress in the negotiation and ratification of treaties.—Although the Treasury Department makes public announcements of the status of treaty negotiations and holds public meetings to discuss certain treaty issues, as a general rule treaty negotiations proceed in secret and treaty texts are not released until the treaty is signed and ready for transmittal to the Senate for its advice and consent. The confidentiality of the negotiating process is supported on the basis that it permits a full and free exchange of ideas and permits both sides to be more flexible than they otherwise could be.

Nevertheless, questions have been raised as to whether the Congress is sufficiently involved in the negotiation and ratification of the treaties. The only formal action Congress now may take with respect to a treaty is approval, approval with reservations or similar qualifications, or rejection by the Senate. Informally, the Joint Committee staff is consulted by the Treasury Department from time to time. Various Congressmen, Senators, and outside observers have, from time to time, argued for greater Congressional involvement in the treaty process. (See, for example at end of question I, the attached Senate floor colloquy and the attached floor statement of Mr. Vanik, previously mentioned, and the proposals made by Senator Gravel during the Senate Finance Committee's consideration of the Revenue Act of 1978 and the testimony of Carl Nordberg at the Oversight Subcommittee hearings). In view of the significant impact which treaties have on statutory tax policies and the absence of any opportunity for the House of Representatives or for either tax-writing committee to participate in the formulation or approval of the treaties, some have argued that tax treaties should not be self-executory, but that implementing legislation should be required before tax treaties go into effect. Alternatively, it has been suggested that a "tax agreement" procedure should be developed, patterned on the trade agreement procedure instituted pursuant to the Trade Act of 1974, under which the Administration consults extensively with the relevant Congressional committees before a trade agreement is formally concluded and submitted to the Congress.

Congressional review of treaties.—The suggestion has been made from time to time that Congress should undertake a thorough review of the U.S. tax treaty program.[4] To my knowledge, with the single exception of the Oversight Subcommittee's recent hearings, U.S. tax treaty policy has only been considered on an ad-hoc basis in connection with a treaty (such as the recently ratified income tax treaty with the United Kingdom) which happens to present a controversial issue. A comprehensive review of U.S. tax treaty policy would permit the Congress to establish and guide that policy more effectively.

In addition to reviewing the existing network of income, estate and gift tax treaties, it would be particularly useful for Congress to review the U.S. model income tax and estate and gift tax treaties. These are extremely important documents in the treaty negotiation process because they represent the initial bargaining position and treaty policies of the United States in treaty negotiations. Notwithstanding their significance, however, Congress does not participate in their development (except to the extent that they largely reflect provisions which are contained in various existing U.S. tax treaties), nor has it ever undertaken a review of the model treaties and the policies they embody.

Sunset.—U.S. tax treaties are of indefinite duration. One current treaty (Sweden) is over 40 years old, and about one-half of the existing U.S. treaties are over 20 years old. Many of these older treaties are seriously out of date, and several contain provisions which would not likely be approved by the Senate, at least in their present form. The United States has no institutionalized system of review and revision of its tax treaties, although Treasury has devoted substantial resources in recent years to the modernization of outdated treaties.

One option which might be considered would be for the United States to adopt the policy, either through legislation or through the treaties, that all of its tax treaties should be of finite duration—e.g., 25 years. This would guarantee that the treaty network would not get to be too far out of date. It would, in addition, give the Senate more control over tax treaty policy by requiring all existing treaty relationships periodically to be subject to its review and approval, and it would give the Senate more latitude in deciding whether to approve the revised treaties and to continue the treaty relationship if the consequence of rejecting the revised treaty would not be the perpetuation of the possibility less desirable existing treaty but rather no treaty at all.

[Attachments]

[A. House floor statement of Mr. Vanik—Congressional Record, June 28, 1978 (H. 6087)]

SENATE ACTION ON TAX TREATY END-RUNS THE CONSTITUTION

(Mr. VANIK asked and was given permission to address the House for 1 minute and to revise and extend his remarks and include extraneous matter.)

Mr. VANIK. Mr. Speaker, yesterday, the other body voted approval of a so-called tax treaty between the United States and the United Kingdom. The other body has the clear constitutional duty to ratify treaties—but yesterday's action was not so much a treaty as it was a tax and revenue bill. The Constitution clearly gives the power of originating tax legislation to the House of Representatives. In addition, precedents going back to the founding of the Nation clearly show that international agreements affecting the revenues must be approved by both Chambers.

I do not know which individuals and companies the tax agreement affects; the House has had no opportunity to hold hearings or debate the proposal and its effect on the revenues or the tax code.

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[4] For example, in his floor statement (Cong. Rec. S8808: July 9, 1979) in support of the third protocol to the U.K. income tax treaty, Sen. Javits advocated such a review as follows:

"To assist the Senate with its constitutional duties, I shall ask the chairman of the Foreign Relations Committee to have the committee undertake a thorough study of our tax treaty program. Such an in-depth analysis, which would include hearings with expert witnesses from the administration and private sector, could focus on the emerging requirements for tax treaties resulting from these conflicts in national taxation systems and whether the procedures followed by the Treasury for both public and congressional involvement in the tax treaty making process are adequate and whether and how they could be improved. I look forward to working very closely with the distinguished chairman of the Foreign Relations Committee as well as with the international tax experts of the Joint Committee on Taxation in this endeavor."

This tax giveaway in treaty clothing is a serious end-run of the Constitution. I believe that this United States-United Kingdom agreement may be subject to challenge by public interest groups in the courts. It is certainly subject to question when we next consider the budget resolutions.

Tax laws should not be written by the striped pants boys—they should be written as the Constitution directs, by the House and then by the Senate.

We cannot countenance tax ripoff by treaty.

[B. Senate Floor Debate and Action on Prior U.K. Treaty, June 1, 1946, 79th Congress, 1st Session, 92 Congressional Record 6108–6110]

[*P. 6108*] CONVENTION WITH GREAT BRITAIN AND NORTHERN IRELAND WITH RESPECT TO TAXES ON INCOME

Mr. CONNALLY. Mr. President, I ask unanimous consent for the present consideration of Executive D, a convention with Great Britain and Northern Ireland with respect to taxes on estates of deceased persons.

The PRESIDING OFFICER. Is there objection?

[*P. 6109*] There being no objection, the Senate, as in Committee of the Whole, proceeded to consider the Convention, Executive D, Seventy-ninth Congress, first session, a convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Washington on April 16, 1945, which was read the second time.

(The convention was printed in the Congressional Record, vol. 91, pt. III, p. 3853, Apr. 26, 1945, at the time the injunction of secrecy was removed.)

Mr. TAFT. Mr. President, without questioning the competence of the Committee on Foreign Relations, it occurs to me that possibly the Committee on Finance should have something to say about this matter.

Mr. CONNALLY. The Senator from Georgia [Mr. George], chairman of the Finance Committee, was chairman of the Subcommittee of the Committee on Foreign Relations which considered this convention. It came under the scrutiny of the chairman and other members of the Finance Committee, and was originally reported by the committee, and later recommitted for further screening.

Mr. TAFT. Who were the members of the subcommittee?

Mr. CONNALLY. I do not know, other than the Senator from Georgia [Mr. George]. He was the chairman.

Mr. TAFT. Did he recommend favorable action to be taken on the treaty?

Mr. CONNALLY. Yes.

Mr. TAFT. I have no objection, Mr. President.

Mr. WHERRY. Mr. President, reserving the right to object, I ask the Senator from Texas if the Senator from West Virginia [Mr. Revercomb] has consulted with him about this convention.

Mr. CONNALLY. I do not know. I have been available for some time, however.

Mr. WHERRY. I understand that the Senator from West Virginia has asked that consideration of one or two of these matters go over, and I was wondering if this was one of them.

Mr. CONNALLY. I am sure that the convention was given very careful consideration.

Mr. TAFT. I have been handed a copy of Executive D which seems to be something entirely different from the Executive D which is on the calendar. It was reported yesterday.

Mr. CONNALLY. Oh, no; this Executive D was reported on the 10th of May.

I may say to the Senator that one of the items which caused Executive D to be recommitted to the committee was the claim which had been made by representatives of the moving-picture industry, including actors, that they were being taxed both in the United States and in the United Kingdom, and that it amounted to double taxation. The convention was recommitted to the committee, and the part about which there had been complaints was rectified. The Senator from Wisconsin [Mr. La Follette] is present and he can give assurances to the Senator from Ohio that the convention is in proper shape.

Mr. LA FOLLETTE. Mr. President, insofar as the treaty which has to do with the United Kingdom is concerned, I may say that there was vigorous protest registered on behalf of the actors and motion-picture producers. I do not have a copy of the treaty before me. However, there was one section of it which the actors and motion-picture producers felt discriminated against them. Therefore, the treaties were returned to the committee for further consideration. The procedure which was worked out was to not change the treaties in any respect. We were assured by representatives of the Treasury Department and of the State Department that they had drawn up a protocol which, as I understand, was to have been signed and submitted to the British Parliament with the recommendation on the part of the British Government that it be approved by the Parliament. It will also have to be approved—I am referring now to the protocol—by the Senate after the British Parliament has acted upon it. It is anticipated that since the Government of the United Kingdom has agreed to it there will be no difficulty about a favorable action on their part being taken with regard to the protocol.

Mr. TAFT. The Senator feels, does he, that the treaty does not give any special advantage to the residents of Great Britain?

Mr. LA FOLLETTE. I believe that since we have worked out what we believe will be a procedure to rectify the discrimination which the actors and motion-picture producers contended they were laboring under, and if the protocols are acted upon subsequent to our ratification of the treaty, the situation of the motion-picture people will have been corrected.

While I am on my feet I wish to make a general statement for the record concerning these tax treaties. The procedure which has usually been followed, and which was followed in this case, is to have the State Department, in conjunction with the Treasury Department, draw up tax treaties. Like all other treaties, the drafting and negotiating of them are carried on in secret. They are then submitted to the Senate for ratification. We are always in the position of either having to take the treaties as we receive them or risk delay or, perhaps, rejection if we amend them.

The particular matter which we have just been discussing is a case in point. I believe that the procedure which has been worked out for this particular treaty—the protocol procedure which I have described—will rectify the situation in this particular case. But, as a member of the Committee on Finance and as a member of the Committee on Foreign Relations, I should like to emphasize the statement made in the original report from the Committee on Foreign Relations—that some other procedure should be found in the drafting of tax treaties whereby the Congress will be apprised of what is contemplated and will be advised of what is intended to be incorporated in such treaties, so that we will not be confronted with such situations as we have discovered, not only in connection with this treaty but in connection with other tax treaties which have been drafted.

My own view is that the staff of the Joint Committee on Internal Revenue Taxation should be drawn into these negotiations, so that the members of the Joint Committee on Internal Revenue Taxation will be privy to the matters which are being negotiated, and the drafts of the treaties as they are being made. Thus, we will not be in the position of being confronted with faits accompli when tax treaties are drawn. I think we have a right to make a special differentiation between the methods used when tax treaties are drawn and those employed when other treaties are drawn because the matter of taxation is so peculiarly a responsibility, first of all, of the House of Representatives, where all tax legislation must originate, and, secondly, the Senate, which must also act upon tax matters.

Mr. TAFT. Mr. President, will the Senator from Wisconsin yield?

Mr. LA FOLLETTE. I yield.

Mr. TAFT. The Senator knows the Finance Committee gives very careful consideration to every detail of a tax bill, it works it all out, then a treaty comes along and the provisions are changed without any consideration by the Committee on Finance itself. It happens in this case that the distinguished chairman of the Committee on Finance is a member of the Committee on Foreign Relations, and has worked on this treaty, and I am willing to take his judgment on it. But in a case, for instance, like that of the reduction in the withholding tax at the source from 30 percent to 15 percent, in the case of dividends moving from the United States to the United Kingdom, with a good deal of care and study we fixed on 30 percent as the rate on dividends going to citizens who are nonresidents of the United States. That is changed, and very properly so, probably, to avoid a duplication of taxation. But it seems to me that the Committee on Finance, through the Joint Committee on Internal Revenue Taxation, should give some consideration to the questions in advance.

Mr. La Follette. I appreciate the Senator's reenforcement of what I have said, because so far as I am concerned, I serve notice now that I shall not be restrained in my opposition to any future treaties which are submitted which deal with tax problems, unless the Joint Committee on Internal Revenue Taxation and its staff are taken into the proceedings at a time when we can have something to say about the policies which are to be adopted, because obviously a treaty overrides any law which we may have on the subject.

Mr. Connally. Mr. President, will the Senator from Wisconsin yield?

Mr. La Follette. I am glad to yield to the distinguished chairman of the Committee on Foreign Relations.

Mr. Connally. I am in hearty agreement with the Senator from Wisconsin in the statement that the Joint Committee on Internal Revenue Taxation, which has been established by the two Houses of Congress to look after tax matters, should be consulted prior to the final negotiations of these treaties.

[*P. 6110*] To explain to the Senator from Ohio my course in the matter, as chairman of the Committee on Foreign Relations I appointed the Senator from Georgia [Mr. George] chairman of the subcommittee, because of the fact that he was chairman of the Committee on Finance, and would give attention to this particular treaty.

Mr. Taft. Mr. President, will the Senator from Wisconsin yield?

Mr. La Follette. I yield.

Mr. Taft. That is the reason why I am not objecting to the treaty, but I still think that the Committee on Finance, which writes tax bills, should pass on modifications of them made by treaty.

Mr. La Follette. The point is that although the Senator from Texas did appoint the Senator from Georgia, who is chairman of the Committee on Finance, and one or two other Senators who are members of the Committee on Finance, the situation with which we are confronted is that this treaty has been signed, sealed, and delivered, to the Senate for ratification, and we have either to take the risk of rejecting the treaty or delaying its ratification, or swallowing the bitter with the sweet. Therefore I believe that we are justified in urging upon both the State Department and the Treasury Department that the Joint Committee on Internal Revenue Taxation and its staff be drawn into these negotiations from the beginning, so that we may have an opportunity to have something to say about the policies which are to be worked out in connection with these negotiations at a time when our judgment may have some bearing on the outcome.

The Presiding Officer. The convention is before the Senate as in Committee of the Whole, and open to amendment. If there be no amendment to be proposed, the convention will be reported to the Senate.

The convention was reported to the Senate without amendment.

The Presiding Officer. The resolution of ratification will be read.

The legislative clerk read as follows:

"*Resolved (two-thirds of the Senators present concurring therein)*, That the Senate advise and consent to the ratification of Executive D, Seventy-ninth Congress, first session, a convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Washington on April 16, 1945."

The Presiding Officer. The question is on agreeing to the resolution of ratification. [Putting the question.] Two-thirds of the Senators present concurring therein, the resolution of ratification is agreed to, and the convention is ratified.

Question 2. Do you think the income tax treaty provisions being negotiated by Treasury recently on foreign insurers and charitable contributions (new Article 15-A of the U.S./Israel Income Tax Treaty) are consistent with sound and prudent tax policy?

A. TREATY PROVISIONS REGARDING FOREIGN INSURERS

Under the Code, foreign insurance companies are subject to the regular U.S. income tax on income derived from insuring U.S. risks where their U.S. insurance activities constitute a U.S. trade or business. Foreign insurance companies not engaged in a U.S. trade or business are subject to a 4-percent (sometimes 1 percent) excise tax on U.S. source insurance or reinsurance premiums in lieu of the income tax. (In the case of casualty insurance, the excise tax is imposed in addition to the income tax if the foreign insurer has a U.S. trade or business but is not licensed to write insurance in the State in which the risk is located.)

The recently ratified income tax treaty with the United Kingdom was the first treaty to cover the insurance excise tax explicitly.[5] The treaty treats the excise tax as a covered income tax with the result that U.K. insurance companies are exempt from the excise tax and, in addition, are exempt from the regular U.S. income tax if their income from insuring U.S. risks is not attributable to a U.S. permanent establishment. (For a more detailed description of the insurance excise tax and the relevant U.K. treaty provisions, see the Senate Foreign Relations Committee Reports accompanying the new treaty and the Third Protocol (approved in 1979) and the Joint Committee pamphlet explaining the provisions of the Third Protocol.)

Following the negotiation of the new U.K. treaty, this provision was included by Treasury in its model income tax treaty. As a result, it has been included in several subsequently negotiated treaties, including the Hungarian treaty, the recent protocol to the existing French treaty, and the proposed treaties with Israel and Cyprus. In the case of the French, Israel and Cyprus treaties, however, the insurance excise tax provision is improved by denying the exemption to the extent that the risk is reinsured by the foreign insurance company with a third-country insurer not entitled to the exemption pursuant to a U.S. treaty with that third country.

This has always struck me as a situation where the Treasury negotiators' policy favoring residency basis taxation might better have been observed in the breach. It is clearly a substantial revenue loser. The insurance excise tax raised $60 million in a year in total before U.K. the treaty went into effect. The impact of the U.K. treaty, together with the treaties following it, is essentially to repeal the tax. In part, this occurs because approximately half the premiums for the insurance of U.S. risks which are paid to foreign insurers are paid to U.K. insurers. Moreover, it is probable that non-U.K. foreign insurance companies (including foreign corporations controlled by U.S. persons and insurance companies operating out of tax havens) intending to insure U.S. risks can effectively obtain in many situations the benefits of the treaty exemption either directly by establishing an affiliate in the United Kingdom or indirectly by reinsuring U.S. risks which have been insured by British insurance companies. As the insurance excise tax provision is included in more treaties, the exemption will generally be available to most foreign insurers. (If the proposed treaty with Cyprus is ratified in its present form, it would be extremely easy for third-country insurers to obtain the benefit of the exemption provided in that treaty, as is discussed in the answer to the third question.)

There are also several other points, unrelated to revenue loss, that should be taken into consideration in evaluating the recent treaty provisions exempting foreign insurers from the insurance excise tax. For one thing, the insurance excise tax to some extent protected the competitive position of U.S. insurance companies subject to the regular U.S. tax and regulatory regimes against foreign insurers not subject to those regimes. For another, insurance is a primary type of tax haven activity. It is also one of the principal investment (or at least quasi-investment) activities engaged in by foreign corporations established by U.S. shareholders as a means of avoiding U.S. tax. All things being equal (I realize they are not—the U.K. treaty has some strong pluses), these are activities which should not be made even more attractive through tax treaties.

Finally, if the insurance excise tax is effectively to be repealed, I have some doubts as to the wisdom of making such a radical departure from the status quo in the area through the tax treaty process rather than through legislation. In this case, the issues involved were not really considered in any great depth by the Senate; they were to a great degree lost in the controversy surrounding the treaty, a treaty thought by Treasury and the U.S. business community to be, on balance, extremely advantageous to U.S. interests. There is little doubt that the U.S. concesssion on the insurance excise tax was an important element in the British decision to extend partial benefits of the U.K. imputation system to U.S. parents of British subsidiaries. On the other hand, including the excise tax in that package effectively precluded any serious consideration of whether the provision was sound.

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[5] In a closing agreement between the IRS and U.K. insurance companies in 1966 under the prior U.K. treaty, the insurance excise tax was waived if the U.K. insurance company agreed to be subject to the regular U.S. corporate income tax on its net income from insuring U.S. risks. That closing agreement was open to serious question on several grounds.

B. CHARITABLE CONTRIBUTION PROVISION OF PROPOSED INCOME TAX TREATY WITH ISRAEL

The proposed income tax treaty with Israel, as modified by the proposed 1980 Protocol, contains a provision (Article 15–A) which, under certain circumstances, would allow a U.S. income tax deduction for contributions by U.S. taxpayers to Israeli charities (treated as such for Israeli income tax purposes) and vice versa. In the case of Israeli contributions to U.S. charities, the provision would not apply to the extent contributions to U.S. charities exceeded 25 percent of the taxpayer's U.S.-source taxable income. In the case of contributions to Israeli charities by U.S. corporations, the provision is similarly limited in application to contributions not in excess of 25 percent of Israeli-source taxable income. In the case of U.S. individuals (including, presumably, partnerships and trusts), it is limited to 25 percent of Israeli-source adjusted gross income. The provision operates by treating Israeli charities as U.S. charities, and vice versa, so the generally applicable limitations on charitable contribution deductions would apply to contributions qualifying under this provision. This charitable contribution provision is not typically found in U.S. tax treaties. However, there has been a similar provision, somewhat less restrictive, in the U.S.-Canada income tax treaty since 1956. Under the Canadian treaty, the deduction is limited, in the case of a corporation, to the amount of its Canadian-source taxable income and, in the case of an individual, to its Canadian-source adjusted gross income.

The proposed Israeli treaty provision has created some controversy. Several Members have received letters complaining that a tax incentive should only be provided for charitable activities performed in the United States and that it is very likely that this provision, although reciprocal in form, will basically be only for the benefit of Israeli charities given the predictable flows of charitable contributions. Moreover, the Senate Foreign Relations Committee in 1968 rejected a similar provision which was contained in the proposed treaty with Brazil.[8] Notwithstanding these objections, in my opinion a reasonable argument can be made in support of this provision. (Other objections raised in the correspondence are political in nature, and I take no position with respect to those issues.)

First, under the Code, a deduction is allowed for contributions by individuals to charities even if they use all their funds abroad. (Corporations may deduct charitable contributions only if they are used in the United States. (Sec. 170(c)(2).) The restriction in the Code is only that the charitable organization must be established in the United States. (Even this requirement does not apply in the case of charitable contribution deductions for U.S. estate and gift tax purposes.) There are, in fact, fairly substantial charities organized in the United States, the contributions to which qualify for a U.S. income tax deduction, which perform most of their charitable activities in Israel. (Presumably the restriction in the Code requiring the charity to be organized in the United States is based in part on the administrative considerations involved in establishing whether the organization would qualify as a charitable organization for Code purposes.) Thus, the provision does not appear, as a practical matter, to involve a significant expansion of present law.

Second, in the case of a U.S. taxpayer working or doing business in a foreign country, a strong case can be made for allowing a U.S. tax deduction to charities located in that country as long as the contribution is also deductible for income tax purposes in that country, the deduction is limited to the taxpayer's income from that country, and the U.S. deduction is treated as attributable to foreign-source income in computing the taxpayer's U.S. foreign tax credit limit.

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[8] The relevant portion of the Foreign Relations Committee report provided as follows:

"Article 22 of the proposed Brazilian convention would allow an American citizen, resident, or corporation to receive a tax deduction for contributions to Brazilian charities if (1) the contributions are used entirely within Brazil, and (2) the recipient Brazilian organization has qualified as a charitable organization under section 501(c)(3) of the Internal Revenue Code.

"The only other United States tax treaty now in force which contains a similar provision is the treaty with Canada, and the Committee does not believe that the practice of allowing tax deductions to Americans for contributions to organizations in foreign countries should be expanded by the tax treaty process. The Committee notes that the same objective can be accomplished through domestic law, and does not believe that a proliferation of these activities should be encouraged by treaty. This is particularly true when one considers that the American taxpayer would be subsidizing such charitable contributions to the extent of the tax deduction which would be allowed. Moreover, in the Committee's view, there is no justification for supporting charities organized abroad until positive steps have been taken to correct the abuses found in some of our domestic tax-exempt foundations. It was for these reasons that the Committee was persuaded to recommend Senate approval of the following reservation:

> "The Government of the United States of America does not accept Article 22 of the convention relating to deductions for charitable contributions."

My principal reservation regarding this provision is whether this change might more appropriately be accomplished through an amendment to the Code. With limited exceptions, U.S. tax treaties do not affect the U.S. taxation of U.S. citizens, residents, or corporations (the so-called "saving clause"); that is considered by the United States to be an internal matter which should not be compromised by agreements with other countries. If a provision affecting the U.S. taxation of U.S. persons is fair and reasonable, it should be applied across the board through the Code to all U.S. taxpayers regardless of the foreign countries from which they derive their income. An otherwise fair and reasonable tax benefit should not be denied by the United States to its citizens, residents, and corporations merely in order to retain a possible treaty "bargaining chip." On the other hand, if there are problems with a provision which argue against its inclusion in the Code, it is doubtful it should be agreed to in a tax treaty.

Nevertheless, an argument for allowing a charitable contribution deduction only through tax treaties rather than through the Code is that doing so would permit a country-by-country examination of the foreign tax law provisions relating to charitable contributions to see if they contain safeguards comparable to those in the Code. Moreover, allowing the deduction through the treaties permits a precise definition of what constitutes a qualifying foreign charity through reference to foreign law and the exchange of information provisions afford an opportunity to confirm that a contribution was made to a qualifying charity. I would assume that the judgment has been made by the Treasury in this instance that the Israeli income tax provisions relating to charitable contributions are similar enough to the U.S. provisions so that if a contribution to an Israeli charity would qualify for a deduction under Israeli law, that organization would also have satisfied the requirements of the Code other than country of organization.

Question 3. Please describe the anti-abuse and exchange of information provisions incorporated in the recently negotiated treaties with Cyprus and Malta. Are they adequate?

A. CYPRUS

The proposed income tax treaty with Cyprus generally follows the other recent U.S. income tax treaties and the U.S. and the O.E.C.D. model treaties. To the extent that there are particular problems with the treaty which are different from those generally presented by income tax treaties, they are attributable to the fact that Cyprus is a tax haven in certain respects. First, companies the shares of which, directly or indirectly, belong exclusively to aliens, are subject to tax at a 4.25-percent rate (one-tenth of the regular Cypriot corporate rate) on profits derived from any business carried on exclusively outside of Cyprus (including, as particularly relevant here, profits from U.S. sources). In addition, any dividends paid out of those profits are exempt from Cypriot tax. Also, an exemption is provided for corporations, regardless of their ownership, for income from international shipping operations (including dividends attributable to such income). Cyprus does not have "absolute" secrecy laws of the type found in certain tax havens, but Cypriot law in this regard is based on the British system and, as such, anonymity of the investors in Cypriot corporations can generally be protected from the tax authorities.

In view of the fact that there apparently is little U.S. investment in Cyprus and little investment in the United States which originates in Cyprus, there do not appear to be any particularly strong reasons for entering into a tax treaty with Cyprus aside from any possible foreign policy considerations. Given the decision of Cyprus to adopt, in certain respects at least, a tax haven regime, there are tax policy considerations which argue against entering into the standard U.S. income tax treaty arrangement with Cyprus.

Because of the tax haven problems, the proposed tax treaty contains certain special provisions designed to deny the benefits of the treaty to those using Cyprus as a tax haven. Article 26 of the treaty denies the benefit of the dividend, interest, and royalty rate reductions and exemptions provided in the treaty to any corporation which either (i) enjoys preferential tax treatment, or (ii) is determined, after consultation between the competent authorities, to be owned to a significant extent by nonresidents. A corporation will be considered to be owned to a substantial extent by nonresidents if 25 percent or more of its capital is held of record or is otherwise determined, after consultation between the competent authorities, to be owned directly or indirectly by nonresidents. For purposes of this provision, a corporation that has substantial trading in its stock on a recognized security exchange in either country is presumed to be owned by residents of that country. This presumption may be rebutted upon the presentation of appropriate evidence by the competent authority of the country seeking to deny application of the treaty benefits. Article 5 contains a similar rule which denies the benefit of any provision of the treaty (other than the provisions relating to private pensions and annuities) to income of any person (other than a corporation) which is taxed at a rate substantially less than (less than 50 percent of) the rate which would have been imposed if it were from domestic sources. Finally, Article 10 of the treaty denies the otherwise applicable reciprocal exemption for shipping profits to any corporation which is 25 percent or more owned by nonresidents (using the same presumption regarding publicly traded corporations described above).

The exchange of information article of the treaty is the standard provision found in most U.S. tax treaties. It provides for the exchange of information pertinent to carrying out the provisions of the treaty and of the domestic laws of the countries concerning taxes covered by the treaty.

While its anti-abuse provisions would go further toward preventing the abuse of the proposed treaty by third-country investors than the provisions contained in any other U.S. income tax treaty, they would not be sufficient to stop all exploitation of the treaty by third-country investors availing themselves of the Cypriot tax haven benefits. First, the corporate anti-abuse provisions in the proposed treaty only extend to the shipping income and dividends, interest, and royalties; consequently, third country investors deriving other types of income from the United States could claim treaty benefits and still take advantage of the special Cypriot tax haven regimes. Thus, for example, an insurance company based in any other tax haven such as the Bahamas apparently could establish a Cypriot subsidiary which qualified for the special Cypriot low-tax regime for foreign income and, as long as it did not maintain a U.S. permanent establishment, it would be exempt under the treaty from any U.S. tax (both the U.S. income tax and the U.S. insurance excise tax) on income it derived from insuring U.S. risks.

A second problem is that it will be difficult, as a practical matter, for the IRS to detect and establish that nonresidents (or U.S. citizens) have a 25-percent direct or indirect ownership interest in a Cypriot corporation since it is unlikely that the necessary information will be available to the IRS and the IRS will not have the subpoena power to obtain that information. This difficulty is increased in the case of publicly-traded Cypriot companies since they would be presumed under the treaty to be beneficially owned by Cypriot residents. One possible indication of significant foreign ownership would be if the Cypriot corporation had unusually high interest deductions or similar expenses which substantially reduced its Cypriot taxable income. The ability of the IRS to enforce these restrictions against Cypriot corporations substantially owned by nonresidents would be greatly increased if the burden was clearly on the corporation to establish to the satisfaciton of the IRS that it was not so owned.

Third, although the treaty does contain standard exchange-of-information provisions, based on the U.S. experience with other treaty partners which promote their use as an investment channel for third-country investors seeking anonymity, there is some question as to how aggressively Cyprus would carry out the exchange-of-information provisions. Also, it is possible that, as in the case of certain other U.S. tax treaty partners, Cyprus' bureaucratic infrastructure is not adequately sophisticated to provide the IRS with the information and assistance it would need to prevent abuse of the treaty. Finally, since its internal law in this area is based on the British system, the information which it could supply to the IRS would apparently be fairly limited.

B. MALTA

To the best of my knowledge, Malta is not presently a tax haven, and I am unaware of any indications that it is considering the adoption of any haven provisions.

The proposed treaty contains the standard exchange of information provision. It does not contain any special anti-abuse provision other than the investment or holding company provision of the U.S. model. This provision (Article 16 of the proposed treaty) is of fairly limited scope; denying the benefits of the dividend, interest, and royalty rate reductions and exemption only in the case of corporations which both (i) enjoys preferential tax treatment, and (ii) is 25 percent or more owned by nonresidents. (Contrast the proposed treaty with Cyprus which denies these benefits if either of these two conditions exist.)

Mr. GIBBONS. Our next witness is one we requested to come and appear before us today, Dr. Barry Spitz, who is going to talk about the use and abuse of the U.S. tax treaty network to reduce or eliminate taxes. He is going to tell us about it specifically from a European point of view. You are breaking new ground. We are delighted to have you here.

STATEMENT OF BARRY SPITZ, BARRISTER, GRAY'S INN

Mr. SPITZ. Thank you, Mr. Chairman. You asked me to discuss the ways in which the U.S. tax treaty network is used to reduce or eliminate global tax burdens. I wish to make a few remarks first of all from the point of view of U.S. taxpayers using treaty conduits and, second, from the point of view of nonresident taxpayers who are not bona fide residents of treaty countries.

With regard to U.S. businesses multinationally based in the United States operating abroad, there are benefits in using tax treaties in order to get foreign barriers to trade removed. To a minor extent, tax treaties are a catalyst to world trade.

I will discuss just three examples, but there are innumerable examples. Let us say we have a U.S. corporation with a Belgian subsidiary. If interest payments were paid, if dividend payments were paid directly, there would be withholding tax in Belgium of 15 percent. Of course, credits do apply in the United States, but this is only a credit against the profits in the hands of the U.S. corporation. If at any particular time the U.S. corporation did not have taxable profits, the credit would be valueless. Now, going through the Netherlands as a conduit, that 15 percent can be reduced to just over 5 percent.

A second example consists of interest payments from Greek-Irish subsidiaries of a U.S. parent. These can be reduced from over 30 percent to zero if effected through a United Kingdom corporation. In other words, one is using the tax treaty between Greece and the United Kingdom and the tax treaty between the United Kingdom and the United States as a conduit.

The third example is a simple example of the way in which a foreign country, such as Australia, would tax technology. It is true that there is a tax treaty between the United States and Australia which covers a number of payments for technology. Many of these do not receive the benefit of the tax treaty. Australian tax—I think it is now 47½ percent—would be imposed on these technology payments. If, on the other hand, a United Kingdom corporation were used as a conduit, the tax burden would be reduced to 10 percent.

Now, my objective is to point out that the United States is not always at the losing end when it comes to treaty shopping. It is possible for U.S. corporations that are having a great battle at the moment in holding their own against foreign competition to use tax treaties where this is tolerated by countries such as the United Kingdom.

I wish to distinguish the United Kingdom and certain other countries which do not market their tax treaties from those which do. Looking at the other side—and that is the position of nonresident taxpayers who are not bona fide residents of treaty countries and receive the benefit of U.S. treaties—the most scandalous case of abuse is the Netherlands. The finger has been pointed to the Netherlands Antilles, but the Netherlands Antilles is a weak stepsister of the Netherlands itself when it comes to this particular problem.

I would be happy if time were to allow me to expound on the way in which the Netherlands can be used for the avoidance of tax on a worldwide basis and for the extraction of income out of the United States without there being withholding taxes inside the United States on the revenues that go out.

The Netherlands Antilles is well known to all of the members of the subcommittee. It has already been described by Mr. Brockway. Comically, the expression "the Dutch sandwich" is used to describe the relationship where money comes out of the United States into the Netherlands Antilles, then to the United States and back to the Netherlands Antilles, using elements of Dutch law and elements of the Netherlands Antilles law in combination to reduce what would be the 30-percent tax burden in the United States to something that barely goes above 2 or 3 percent.

Switzerland has been used as a royalties conduit. I want to talk further about Switzerland. Switzerland is not one of the enemies of the United States when it comes to the extraction of income at the present time.

The British Virgin Islands does have tax. The British Virgin Islands can be used for the purpose of extraction of income from the United States without withholding tax, but with difficulty. There is no major loss through the British Virgin Islands.

One rule that perhaps ought to be understood is that in all British jurisdictions, taxation is based, in the case of corporations, on residence, and therefore a corporation that is not resident—in other words, managed and controlled in the United Kingdom or in South Africa or in the British Virgin Islands—would not be liable for tax on income. This is a basic British rule of taxation. In such a case, the tax treaty would not apply.

Say, for example, you had a British corporation or British Virgin Islands corporation that was not paying tax as a resident in those countries. The tax treaty would not apply because it would not be resident. Therefore, the British Virgin Islands is not one of your big enemies in this particular game.

I have a number of commentaries I would like to make on this particular point. In the first place, there is the systematic marketing of its treaty networks by the Netherlands, which has extremely wide networks in the Netherlands Antilles. In addition there are a number of countries that can be used as treaty conduits, but are not commercializing this possibility.

For example, the United Kingdom simply applies its normal corporate tax law without worrying about whether there is treaty shopping. It does not see itself as a victim nor does it commercialize on the possibility of using the United Kingdom, as in the examples I gave earlier.

South Africa, surprisingly enough, because the tax is on the basis of territoriality, can be used as a perfect tax treaty conduit. South Africa does not seek this kind of business in any way whatsoever. In fact, if it were used, the South African Government would block it. This does not detract from the fact that the treaties and internal domestic law do permit the use of such a country.

Another point that is sometimes overlooked is that the United States itself is used as a treaty conduit. In certain cases, Canada has bad treaties or no treaties, and money is transferred from Canada to the United States and then out of the United States through a tax treaty.

So in many cases the United States is an innocent participant, just as the United Kingdom is an innocent participant, in treaty shopping. This is a point made by Mr. Brockway.

The tax treaty test of a permanent establishment is, in certain cases, much kinder to a foreign corporation than the criterion of whether that foreign corporation has effectively connected income, as is the test embodied in the Internal Revenue Code.

I have the view, which I am not able to substantiate, that the existence of a tax treaty does give the United States access to information and an element of control over certain foreign and domestic operations which would be unavailable in the case of tax havens which do not have tax treaties with the United States.

Mr. Brockway made the point that this information is not always used efficiently by the United States. Nevertheless, the ability of the United States does remain there as long as you do have a tax treaty.

The second question which you asked me to address myself to was the approaches adopted by other countries to combat tax haven abuse and tax treaty shopping abuse. Looking first at tax haven abuse, all capital exporting countries have attacked the use of tax havens in one form or another, some more efficiently than others.

In Canada you have foreign accrual income property provisions. In Germany you have the Foreign Tax Act. In the United Kingdom the Tax Act is extremely wide reaching and makes tax haven operation for United Kingdom domestic residents extremely difficult. We find the same in Australia.

In France, too, you have specific provisions in the code and you have a general provision lacking in the United States; that is, the abuse of rights. In other words, even if you were entitled to do something, if you abused your right to do so, this would not be allowed.

I want to address myself now to the prevention of tax treaty shopping abuse. There is only one country that does, in fact, prevent tax treaty shopping abuse and that is Switzerland. Switzerland did not do so in the first instance as a choice. It was forced to do so by its treaty partners.

The extent to which Swiss treaties were abused in the 1950's brought out a negative reaction in the United States, the United Kingdom, France, Germany, and the Netherlands. They threatened in one way or another to terminate their treaties with Switzerland, just as the Netherlands Antilles treaty at one stage was terminated because of abuse.

The Swiss dealt with this problem by passing a Federal decree in 1962. This Federal decree provides reduction of tax withheld, granted by the other contracting states in accordance with provisions of a tax treaty concluded by Switzerland. It may not benefit persons claiming such relief abuse civilly.

Tax relief is considered to be claimed abuse civilly by an individual, a company, a partnership or other legal entity resident in Switzerland if through such claim a substantial part of the tax relief would benefit directly or indirectly persons not entitled to benefits of the Swiss tax treaty and then such claims would be refused.

In other words, Switzerland would say as far as we are concerned the treaty does not apply in the case of abuse. There are four cases that I have dealt with. This book that I wrote is in the Library of Congress. On pages 29 and 30 I have set out the four main cases where the Swiss have prevented abuse of their tax treaties.

Then there are cases which are not to be found in the domestic law of countries but rather in the treaties themselves. Germany is now inserting clauses which reassemble the article XVI of the OECD draft and certain other treaties which are intended to exclude the benefits of favorable tax treatment in the case of nonresidents with indirect claims.

There were two commentaries that I thought might be interesting. I do not really know what lesson can be derived from them. Last month, March 5 through 7, at Strasbourg the Council of Europe held a colloquy on tax evasion and tax avoidance. It was attended by members of governments of the Council of European countries. It was attended also by the EEC and OECD representatives.

No mention whatsoever was made of tax treaty shopping abuse. For 3 days delegates spoke about tax avoidance and tax evasion and the matter of tax treaties was not referred to so far as I am aware.

Whether this is condemnation or possibly tacit approval of treaty shopping is a moot point. I have suggested in my report that this may be read into the silence that was cast upon this question.

There is another commentary that I picked out some while back, in 1973, at meetings of the European community. The question of the abuse of tax havens was raised again and again and just recently, that is on September 25, 1979, Mr. Debray issued a written question and the commission of the European communities made the following statement. I will quote the statement:

> As regards tax avoidance, particularly through the use of tax havens, the commission emphasized in its report of 18 June, 1973, on the tax arrangements applying to holding companies that any tax taken in isolation by the communities would be inappropriate since it would inevitably lead to an outflow of capital to nonmember countries,

and that only concerted action in a wider international context could achieve the desired results.

It is my view all capital exporting countries should act in collaboration with one another in this matter. Regretfully, it is sometimes to be found that allies do not collaborate as closely as allies might be expected to and even countries with common economic interests do not collaborate with one another as effectively as they ought to.

In conclusion, I wish to say there is a line to be drawn between tax treaty shopping where this is a part of business, an ordinary part of business, and where a country is actually commercializing the abuse. If any of the members would like me to discuss the way in which the Netherlands actually abuses its tax treaties I should be pleased to expound on this matter further.

[Mr. Spitz' prepared testimony follows:]

RÉSUMÉ OF TESTIMONY ON TAX TREATIES PRESENTED BY BARRY SPITZ

1. WAYS IN WHICH THE U.S. TAX TREATY NETWORK IS USED TO REDUCE OR ELIMINATE GLOBAL TAX BURDENS

(a) By United States taxpayers using treaty conduits

It is common practice for U.S. corporations to use treaty conduits in order to reduce global tax burdens: for example—

(i) Belgian withholding taxes on dividends paid by Belgian subsidiaries to their U.S. parents can be reduced by payments being effected through a Netherlands holding company benefiting from the Netherlands affiliation privilege (Article 13(1) of the Wet op de Vennootschapsbelasting—Corporation Income Tax Act).

(ii) Interest payments from Greek or Irish subsidies to a U.S. parent can be reduced from over 30 percent to zero if effected through a United Kingdom Corporation.

(iii) A U.S. supplier of technology to Australia would be subject to Australian tax on certain payments at nearly 50 percent. This could be reduced to 10 percent if effected through a United Kingdom corporation.

Commentary: The blockage of treaty shopping would carry with it the risk of hampering international trade and commerce and interefering with United States operations abroad.

(b) By nonresident taxpayers who are not bonafide residents of treaty countries

The principal base countries with tax treaties with the United States are:

(i) The Netherlands: used especially for royalties, dividends (other than in respect of portfolio holdings), interest payments, direct investment.

(ii) The Netherlands Antilles: Similar to the Netherlands.

(iii) Switzerland: used especially for royalties.

(iv) British Virgin Islands: used especially for portfolio investment and to a lesser extent for direct investment.

(v) Belize (British Honduras).

Commentary 1: There would appear to be a systematic marketing of their treaty networks by the Netherlands (which has an extremely wide network) and the Netherlands Antilles. Note: in many cases the Netherlands and the Netherlands Antilles are used together with one another for internal as well as international fiscal reasons.

Commentary 2: In addition, the treaties of many other countries can be used as a conduit for the benefit of nonresidents, e.g. the United Kingdom (including many of the former colonies to which the old United Kingdom tax treaty had been extended), the Republic of South Africa, the Scandinavian countries. There does not appear to be a purposeful commercialization of their tax treaties by these countries.

Commentary 3: The United States itself may be used as a tax treaty conduit in certain circumstances, e.g. in respect of certain payments originating in Canada.

Commentary 4: A common use of tax treaties with the United States is not necessarily as a conduit at all. The criterion of the absence of a permanent establishment is in certain cases kinder to a foreign corporation than the criterion of income effectively connected with the carrying on of a trade or business in the United States.

Commentary 5: The existence of a tax treaty does give the United States access to information and an element of control over certain foreign and domestic operations which would be unavailable in the case of tax havens which do not have tax treates with the United States.

2. APPROACHES ADOPTED BY OTHER COUNTRIES TO COMBAT TAX HAVEN ABUSE AND TAX TREATY SHOPPING ABUSE

(a) All sophisticated tax systems have anti-avoidance measures to combat tax haven abuse:

For example—
(i) Canada: Foreign accrual property income provisions
(ii) Germany: Aussenstuergesetz (foreign tax act)
(iii) United Kingdom: Taxes Act secs. 478, 482, 485
(iv) Australia: Taxation Administration Act; Banking Act
(v) France: Code Général des Impôts arts. 57, 638A; 155A;

(b) Prevention of Tax Treaty Shopping Abuse

(i) Switzerland is the only country with comprehensive measures against the abuse of tax treaties. The Federal Decree of December 14, 1962 (Arrête du Conseil fédéral instituant des mesures contre l'utilisation sans cause légitime des conventions conclues par la Conféderation en vue d'éviter les doubles impositions) provides that reduction of tax withheld at source granted by the other contracting state in accordance with the provisions of a tax treaty concluded by Switzerland may not benefit persons claiming such relief abusively. Tax relief is considered to be claimed abusively by an individual, a company, a partnership or other legal entity resident in Switzerland if, through such claim, a substantial part of the tax relief would benefit, directly or indirectly, persons not entitled to the benefits of a Swiss tax treaty. Such claims are refused.

(ii) Certain tax treaties specifically exclude the benefits of favorable tax treaty treatment in the case of nonresidents with indirect claims, e.g. recent German tax treaties.

Commentary: It is highly significant that at the recent Strasbourg Colloquy on Tax Evasion and Tax Avoidance held by the Council of Europe on March 5 through 7, 1980, no reference whatsoever was made to treaty shopping even though representatives of various governments and of the O.E.C.D. and the E.E.C. were persent. The condonation and possibly even the tacit approval of treaty shopping may be read into this.

Commentary: The reply to Written Question No. 561/79 addressed to the Commission of the European Communities (September 25, 1979) by Mr. Debre, contains the following statement "As regards tax avoidance, particularly through the use of tax havens, the Commission emphasized, in its report of 18 June 1973 on the tax arrangements applying to holding companies, that any action taken in isolation by the Community would be inappropriate, since it would inevitably lead to an outflow of capital to nonmember countries, and that only concerted action in a wider international context could achieve the desired results."

Professional qualifications.—Admitted to the South African Bar, 1956; English Bar, 1963; Cayman Islands Bar, 1974; British Virgin Islands Bar, 1979.

Academic qualifications.—B.A.; Ll.B. of the University of the Witwatersrand, 1955. Doctor (summa cum laude) of the University of Paris Faculty of Law and Economics, 1963—special mention at prize-giving. Diploma of International Law of the Hague Academy of International Law, 1960. Diploma of Comparative Law of the Luxembourg International University, 1963.

University appointments and seminars.—Adjunct Professor of the Rice University Graduate School of Administration (international tax planning), 1978–79—Houston. Guest lecturer at the Law School of the University of the Witwatersrand. Seminar leader at: international tax; international estate and trust planning; tax havens Seminars—in the United States, England and France.

Appointments.—Secretary General of the International Law Association of South Africa, 1965–73; Chairman of the South African Fiscal Association, 1969–73; Member of the General Council of the International Fiscal Association, 1970–73.

Special research projects.—Hague Academy Center for Studies and Research—Conference on Law of Treaties, 1960: Conference on Private International Law (Air Law) 1965. Preparation of pleadings in matters arising before the Hague International Court and the Strasbourg European Court, 1961 and 1962. Direction of Research Team preparing General Index to the Hague Recueil des Cours (125 volumes of public and private international law). Senior research consultant of the International Bureau of Fiscal Documentation, Amsterdam, 1968–69. Design

of Computer Program and Special Purpose Language for International Tax Planning, 1972–73.

Books and articles.—**Inégalité *par* loi (University of Paris, 1963). European Taxation (Editor 1968–69); Value Added Taxation in Europe—French section (International Bureau of Fiscal Documentation, 1973). International Tax Planning (Butterworths, London, 1972) (Japanese Translation, Tokyo, 1975). Spitz Tax Havens Encyclopaedia (Butterworths, London, 1975) (updated looseleaf service). Articles on subjects of international law and fiscal law appearing in various legal, accountancy and business management journals.**

Mr. GIBBONS. I have to ask you that question because it intrigues me. You say the Netherlands are the principal problem and the Netherlands Antilles is just an ancillary problem, is that correct?

Mr. SPITZ. I could not give statistics since they would be unavailable to me. Clearly a lot of tax dodging that is done in the United States is done through the Netherlands Antilles and the line between tax evasion and tax avoidance in the Netherlands Antilles would not be clear.

The Netherlands Antilles form of cheating on the treaty would be by way of reducing the tax base. In other words, they would say to the United States, "We will keep the rates," and in private they would allow a portion of the base to be paid out in management fees to some other corporation.

So, there you have the seeming respect for the requirements of the United States, without the reality of respect.

In the case of the Netherlands, you have strict adherence to law. We are not talking about evasion in any way whatsoever. It is the law itself which allows for the treaty shopping system to operate.

Mr. GIBBONS. The Netherlands law?

Mr. SPITZ. The Netherlands law together with the treaties of the Netherlands as concluded.

If I could run through the various types of activity, it might be interesting to see how this works. The Netherlands Corporation Tax Act has a simple rule that seeks to avoid double taxation. The principle is, "If tax has been paid somewhere, or is to be paid, we will not impose tax twice." So, this is the honorable principle that is expounded.

Under article XIII, particularly XIII(1) of the Dutch law, you will find that there is no Dutch tax imposed at all on a Netherlands corporation which has held an investment. This is not a portfolio investment; it must be 5 percent or some element of control in a foreign corporation. Therefore, assuming you have a treaty between country *x* and the Netherlands which reduced the withholding rate to 5 percent or zero or 7.5 percent, the money would move into the Netherlands at that low rate.

The Netherlands itself, provided certain conditions were fulfilled, would not impose tax. The one condition is that the holding should have taken place since the beginning of the tax year. It must be for a full tax year. The other condition is that the payment must be made out to a country that does impose some tax. The Netherlands Antilles in certain cases imposes a tax rate of 2.4 to 3 percent.

Therefore, the route is from the foreign country, into the Netherlands, out of the Netherlands to the Netherlands Antilles. This is a Netherlands-Netherlands Antilles game.

You may ask, what is in it for the Netherlands Government? A company has been incorporated, there has been a certain amount of work for the company, ceratin fees have been paid, and accountants and attorneys have received a certain benefit .

Turning now to interest payments: It is true that the *Aiken Industries* case made it a lot more difficult to do back-to-back arrangements where you have an equal amount being lent and an equal amount being borrowed.

The way in which the Dutch would operate is as follows: In many of the treaties between the Netherlands and other countries the tax, the withholding rate, is reduced to zero in the case of interest payments as you will find in the case of the United States. This even goes as far as interest payments where there is security by way of a mortgage, and that is not the case in many other countries.

So, the United States would charge zero. The payments would be made to a Netherlands corporation or a bank assuming the *Aiken* case were not to apply on particular facts. Another corporation could allow the loan to go through the Netherlands, receiving and paying an agent as a conduit, and all that the Netherlands would do would be to tax the spread of interest rate.

It would insist on minimum spread, one-half or one-quarter of a percent. It would impose its tax, which is standing now at 48 percent, on that spread. Nevertheless, the extraction of income goes right through it. It flows right through exactly as if a plumber had put pipes together and a little water remained on the way.

The third way that the Netherlands uses its tax treaties is by way of a royalties conduit. Now, in the case of the dividends you can enter into an arrangement with the tax administration; you know exactly where you stand. This is an arrangement that will be made by the Tax Office.

In the case of dividends, you have a choice in the case of dividend payments. In the case of interest payments very often no arrangement is made at all unless you want the Government to accept a fixed amount for the spread. With royalties it is necessary to negotiate an arrangement with the Dutch Government. The Dutch Government will sell you the use of its treaties at a price.

Now, if you would look at the worldwide networks of some 30 or 40 treaties you will find that in nearly every case the withholding tax on payments out of the various treaty partners of the Netherlands is zero. The payment goes into the Netherlands with no withholding and there is no withholding in the Netherlands on payments out.

Therefore, the Netherlands would impose its corporate tax on a limited amount which is subject to negotiation. The tax base usually runs from 7 percent downward to 2 percent of flow. And going up, just a small corporation with, say, 2 million guilders worth of trade, they would charge 7 percent but after the 10 million you get down to the lower slice.

Now, assuming they treated your tax base worldwide as 2 percent and imposed 48 percent tax on that, you are effectively giving the Dutch 2 percent. You need not look much further to see why so many cinema companies and television companies have their offices in the Netherlands.

Now, in order not to seem to be a tax haven and not to seem to abuse its tax treaty, the Dutch require a real presence. You would actually have to have an office in the Netherlands. You would have to have a director who would be receiving a salary that would be taxable in the Netherlands. You would have to have a girl employed that would handle the switchboard.

I am sorry—you would have to have a person—I forgot I am in America. You would have to have a person handling the switchboard and you would have to have enough office space to justify the business.

Now, in fact you can see that there is revenue for the Dutch Government that it would not otherwise have. Now where you are looking for your enemies, you do need to see that if you wish to stop a major international abuse together with Germany and France and England and Scandinavian countries, you do need to lean on the Netherlands to stop this abuse.

This is a major business being commercialized very effectively by the Netherlands Government.

Looking at the United Kingdom and the fact there might be treaty abuse or treaty shopping, you do not have an active commercializer as a possibility.

Now, the last thing I wish to state is that treaty shopping is not necessarily an evil. I do repeat what I said in many cases this is good for business. There are certain cases where certain countries are extracting revenue out of countries such as the United States, and the United States by no means is the only victim. Germany is an equal victim. The United Kingdom is an equal victim and this is something which is being marketed.

Now, very discreetly if you were to telephone the Ministry of Finance the reply you would get is that the Netherlands is a tax haven; you cannot do that. But if you knocked on the correct door on the Tax Office in Amsterdam you would get just such an arrangement as I have described.

Mr. Gibbons. Mr. Gradison?

Mr. Gradison. Thank you, Mr. Chairman.

First I want to thank you for your very helpful testimony and your willingness to be with us this morning. Here in the United States there is some talk about eliminating our 30 percent withholding tax on interest payable to foreign holders of interest bearing U.S. investments.

What effect would the elimination of such a withholding tax have, if any, on what you are discussing and in particular on the United States itself being used as an effective conduit?

Mr. Spitz. I think it is like water finding its lowest level. Money is floating around the world in gigantic sums. You only have to look at Europe and the market is in the trillion area. It is gigantic. There is more money in the world; there is more investment money than can be imagined.

I am answering indirectly. Where Hong Kong had a withholding tax on interest payments, Hong Kong did not become the center of the Asian dollar market. Singapore skillfully realized that by the removal of the withholding tax on interest payments it could become the center of inter-Asia's dollar market.

The investment money throughout the world goes where there is no tax. It is rather like the flag of convenience of the old days. One took the country where there would be no taxes. Similarly, money will move where it is not taxed. One can quite readily see if capital gains tax now imposed on profits on the stock market was increased, you could get Dow Jones to drop overnight by one-half or one-quarter.

In a way there is clearly certain money that goes where there is no tax. Now, in many respects the United States is a tax haven for a foreigner. Just by virtue of the fact the foreigner receives more kindly treatment from a tax point of view in the United States than an American would receive is an inducement for the foreigner to invest in the United States.

The United States is not a source of complete parity even when it comes to, for example, gains on real estate. In following through the development of certain farms and so on there might be a change, but it is nevertheless not the U.S. Government policy at the present time to put all foreigners on a level of equality with U.S. taxpayers.

Obviously anything that were to remove a tax barrier would attract money. The attitude of foreigners is that the United States is the last bastion of capital.

Mr. Gradison. It shows you how far we have gone.

Mr. Spitz. You can socialize your country without anybody noticing it. The fact remains for the bulk of the world this is the one good place in which to invest. The removal of certain tax barriers would attract more money. The United States is very desirable to the rest of the world.

I probably answered your question very indirectly but I hope I have come to the point you want.

Mr. Gradison. I understand it would stimulate the flow of investment dollars into the United States and I assume that is one of the objectives of it.

I am not clear as to the extent to which the lifting of the withholding tax would stimulate the flow of such funds into the United States as part of an overall scheme of tax reduction or tax evasion; not just seeking a safe high return but the other element which we have been discussing here as well.

Mr. Spitz. I think you can probably assume that today the United States is one of the world's major recipients of tax evasion money. Switzerland probably pales by comparison with the United States.

Mr. Gradison. I am glad we are first in something in the world.

Mr. Spitz. I am not an economist and I cannot answer your question. Basically my clients tend to be multinationals doing everything lawfully. The person who has money to invest does not come to see the tax technician. The Swiss banks, the Dutch banks and the United States banks and the Canadian banks—not Bermudan banks—give him a service that no lawyer can ever give him.

Mr. Gibbons. What types of businesses principally use the Dutch package—just the Dutch, not the Netherlands Antilles package?

Mr. Spitz. Holding companies that need to hold stock through subsidiaries. This is a very fine base for a multinational interest that receives dividends income from its subsidiaries. When it comes to the bank, just the fact of the back-to-back load aides Dutch banking, which is very strong in the world.

Insofar as royalties are concerned and technology, that is everything. That can be intellectual rights as well as industrial rights. It could relate to an invention of offshore technology. It could relate to video tapes but it is ideal for the receipt of cinema royalties and television royalties.

I would say the strongest group in the Netherlands alone would be the cinema group. There is, of course, the computer technology. It is more difficult, of course, to patent certain programs but insofar as you can have intellectual property or you can have industrial property, the Netherlands would be an ideal base for your corporation.

Mr. **Gibbons.** Why don't we collaborate with each other and work these problems out? You say we do not collaborate very well.

Mr. **Spitz.** There seems to be too much difference at the starting point. Systems of tax are too dissimilar from one another. If you look at the nine countries of the EEC, you see how difficult it is for them to agree on a farming policy and on correct taxation of matters like milk and lettuce. To take this further, to the level of major collaboration, seems to be impossible.

This is something that goes back to the early conferences. I think, in fact, the early OECD model tax treaty drafts remained pending nearly 40 years. The very fact that there is a model treaty shows a measure of collaboration. It would seem that the differences internally in the tax systems are so extreme that the tax treaties themselves cannot really join—it is like papering over cracks if you have a lot of different materials underneath your wallpaper.

But there is partly a lack of willingness. One only has to see how willingly nine were to collaborate at times of economic expansion and the moment there is recession how everyone becomes protectionist. I think the national interest does tend to dominate the international, and the world community at large does not collaborate in as positive a way as it should.

Mr. **Gibbons.** What countries in terms of geographic interests are the principal losers because of this network of tax treaties and particularly the Netherlands tax treaty?

Mr. **Spitz.** I could not answer a question like this and I do not think anybody in the world could. The likeliest is that the richer countries with more technology and more to offer would be the bigger losers. In other words, we would expect the countries to be the United States, Germany, to a lesser extent the United Kingdom, to a certain extent France. It is a difficult question to answer because I do not think anybody really would have any statistics in the matter.

The thing I can say is that you are in an area that is lawful. The Dutch law sets out the position absolutely clearly. The agreements entered into between the corporations and the Dutch tax administration would be made available to the U.S. Government.

This is not the Cayman Islands we are dealing with where everything is secret and black money is being dealt with. This is part of international business activity and it may even be argued that the activity of the Dutch facilitates international trade. It would be hard for me to say this is necessarily an evil.

The loss of tax revenue on the one hand might be compensated by the fact there is international trade. Too much tax does discourage domestic activity. How much more does too much tax discourage international activities? It would not be in Americans' interest; it would be difficult for United States films, for example, to be shown abroad.

I do feel, though, the abuse is there. You can get statistics on the abuse and you can calculate whether the trade benefits do compensate the abuse.

Mr. GIBBONS. From your point of view, why is the United States entering into tax treaties with such entities as Malta and Cyprus?

Mr. SPITZ. I find it difficult to understand. I think this is something you must seek inside the United States. I think the one answer given by Mr. Brockway was basically U.S. policy is to tidy up relations with all countries. Of course, there is no reason why a tax treaty with a tax haven country should necessarily contain abuse. A simple clause concluding the abuse would be perfectly adequate.

If you look at the Luxembourg treaty, every country that concluded a treaty, Luxembourg would exclude the holding company; in other words, exclude the one element where there could be treaty abuse. Nevertheless, I am at a loss to understand why the United States would be concluding a treaty with a country such as Cyprus or Malta. This must have been inside U.S. policy. I am the wrong person to ask.

Mr. GIBBONS. Sometimes we have a little trouble understanding things up close and I thought a view from the distance might clarify the picture. Thank you. You have been very helpful and a very interesting and informative witness.

Mr. SPITZ. I thank you very much for the invitation which was an honor to me.

Mr. GIBBONS. Your prepared statement and the statements of the previous witnesses will be placed in the record immediately following their testimony.

The next panel consists of David Rosenbloom, International Tax Counsel, of the Treasury Department; Professor Hugh Ault, Boston College School of Law; Robert Patrick, senior tax counsel, Exxon Corp.; and Carl Nordberg, of the firm of Groom & Nordberg, in Washington, D.C.

This panel is going to discuss U.S. tax treaty policy, what it is and what it should be, to what extent the negotiation process should be more open, and tax-writing committees that might be involved, as well as how treaty provisions are sometimes compromised.

Would these gentlemen come forward?

Mr. Rosenbloom, you have a full statement here, and I would like to listen to all of it, but I am afraid we don't have that much time today. We will put your entire statement in the record at the conclusion of your oral remarks. Would you attempt to summarize it for us?

STATEMENT OF DAVID ROSENBLOOM, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. ROSENBLOOM. Thank you, Mr. Chairman.

Insofar as my research has disclosed, there have not been many opportunities in the past to discuss U.S. tax treaty policy in congressional hearings.

Mr. GIBBONS. We tend to stay away from the things that we don't understand at all. This may fall into that category.

Mr. Rosenbloom. Let's hope we end up with more understanding.

I welcome the opportunity to discuss treaty policy today. I thank you for inviting me to put my statement in the record. It would have kept us here all day, if I had tried to read it. I will try to summarize what is in it.

The essential tax treaty policy of the United States today derives from a lengthy international history and is generally in accord with internationally agreed rules. Those rules rest ultimately on theoretical work that was done in international organizations as long ago as the 1920's. I refer specifically to the League of Nations.

The essential principle underlying the rules is that potential double taxation should be resolved in favor of the state to which the person earning income owes primary economic allegiance with respect to that income. This principle leads to the use of a so-called classification and assignment method of devising specific rules in tax treaties.

The method calls for classifying different types of income and assigning rights to tax each category to the residence state or the source state in accordance with the judgment as to which state has the primary claim to tax that category of income.

In some few cases items of income are assigned to both states to tax.

The international models resolve in favor of the primacy of the source state taxation of income from real property and business income, if it is connected to a fixed location through which the business is conducted. They also may be viewed as resolving in favor of the source state, the taxation of personal service, when services are performed in that state.

Passive investment income, on the other hand, is generally assigned to the residence State, although the international models allow some taxation, subject to prescribed limits in the State of source as well.

Generally speaking, the international rules exhibit a preference for residence-basis taxation subject to defined exceptions for particular types of income. The reason for this preference is closely related to modern notions of progressive income taxation.

Net income is the best measure of a person's overall ability to contribute to defraying the cost of government, and net income taxation is best left for very technical reasons to the State of residence.

It is that State, after all, which is in a position to allow appropriate deductions, give personal allowances, make exceptions for certain categories of worthy persons, and determine tax brackets in accordance with the taxpayer's overall income.

Those kinds of income most readily assigned to the source State—business income connected with a fixed location, real property income, personal service income—really involve a modification of the concept of a taxpayer's residence. This conception of the appropriate division of jurisdiction to tax is reflected in the existing international model treaties for avoidance of double taxation and in existing international bilateral agreements of which there is a wide network throughout the world.

My prepared statement discusses in detail the formulation of U.S. treaty policy based on the bedrock underlying policies that I have just discussed.

As I indicate, the starting point for the formulation of U.S. policy is the primary existing international model, that of the Organization for Economic Cooperation and Development, the OECD.

We are in substantial accord with the principles embodied in that model; but in addition, use of the international model facilitates negotiations with other countries which are familiar with the international rules, and affords a degree of uniformity and predictability to the body of law which emerges from the collection of treaties into which we enter.

There are, of course, provisions which we cannot accept in the international models. I have discussed those in some detail in my prepared statement. Our differences are either because of underlying differences over policy in a relatively few cases, or the way the models implement policy in a greater number of cases, or because of peculiarities of our statutory law or our concept of taxation; and it is that third category that accounts for the greatest number of differences between the U.S. approach to tax treaties and that of the international models.

In my prepared statement I indicate those areas which I believe are the major differences between the U.S. position and that of the OECD.

In addition, I discuss the areas where other differences of a less fundamental nature exist.

Finally, there are a number of issues—and perhaps these are the most significant issues we are facing today in treaty negotiations—which are not discussed in either of the models, either the OECD model or the U.S. model, which have a major effect on the substance of current tax treaty policy.

Your letter inviting my testimony posed six specific questions which I would like now to address directly, because I believe the answers are a bit diffuse in my prepared statement.

First: You asked me to comment on whether the United States should accept the best alternative when negotiating tax treaties, or whether the United States should scrap negotiations when the goals set forth in the U.S. Model Income Tax Treaty are not met.

My prepared statement suggests my views on the extent to which we should accept the best alternative available and when we should scrap negotiations.

Some of the goals embodied in the U.S. model are in our judgment fundamental. Others are not. We do not ever compromise fundamental goals in negotiating tax treaties. When lesser issues are involved, however, we should in my judgment be willing to accept attainable bargains even at the cost of some sacrifice of specific policy goals embodied in the U.S. model.

What is fundamental is of course a matter of judgment and that may vary from country to country and negotiation to negotiation.

Second: You asked me briefly to discuss the negotiating goals embodied in the U.S. Model Income Tax Treaty, compare them with the goals reflected in OECD and U.N. models and comment on whether they are appropriate goals. I think my prepared statement performs the first two functions and I do not think a summary would be able to shorten that statement very much. I do believe the goals embodied in the U.S. model are appropriate, although I would readily concede that the model can be improved.

Third: You asked me to comment on whether tax treaties to which the United States is a party do, and whether such treaties should, have objectives such as benefiting certain U.S. businesses and investors in addition to the announced objectives of the elimination of double taxation and the exchange of information.

The tax treaties do not and should not have the objective of conferring special benefits on certain U.S. businesses or investors. There are of course some circumstances in which there would only be one or a few businesses with substantial operations in a particular country. And in those circumstances we must carefully consider the impact of possible treaty provisions on these persons.

In addition the practical effects of particular sections on particular industries must be weighed. But generally we should always attempt to obtain an agreement which embodies the norms which govern the treaty program generally.

Fourth: You asked how and to what extent should the tax writing-committees be involved in formulating and approving tax treaty policy.

Treaties must be approved by a two-thirds vote of the Senate. And traditionally tax treaties have been assigned to the Foreign Relations Committee, which examines the provisions with the assistance of the staff of the Joint Committee on Taxation.

We do consult regularly if informally with the Joint Committee staff on issues pertinent to treaty policy. The Treasury would welcome the opportunity for consultation with tax writing committees concerning tax treaty policy. Such consultations could be with respect to the design of the U.S. model and the formulation of a general U.S. negotiating position. With respect to issues not fully resolved by the model consultations would probably be done with respect to issues raised by particular negotiations in much the same way Treasury now seeks public comment on the treaties.

We do not believe, however, that procedures should be adopted which would further slow the process of obtaining ratification of tax treaties. Our ratification process is already cumbersome, more so than in most other countries.

Fifth: You asked me to discuss how and to what extent the tax treaty negotiation process can be made more open to the public.

My statement discusses the problems with opening the treaty negotiating process to the public to a greater extent than it already is. Basically, the obstacles here are the policies of our negotiating partners. We are already far out in front of them in opening up this process to public scrutiny and our procedures that we have adopted to date are often not well understood.

I could speak of personal experience in particular negotiations where we have discussed for many hours the desirability of holding public meetings, a procedure we instituted in 1978 and that has been very much to the benefit of Treasury and, I think, also to the benefit of interested members of the public. We will continue to urge our partners to adopt a reasonable view toward our effort to engage the public in the process of formulating treaty policy. But taking major additional steps—such as releasing drafts in advance of full agreement—will not be understood and as a practical matter would make it impossible to deal with many countries of the world.

Finally: You asked me to discuss the principles that are considered by U.S. negotiators in conceding the goals of the U.S. Model Income Tax Treaty during negotiations.

My statement again indicates the principles which guide us in structuring bargains in Treasury negotiations. Basically, we confine such bargains to issues we do not view as fundamental. Subject to this basic constraint, we seek to obtain concessions from the other side, either for the public benefit or for our taxpayers in exchange for any concessions we make. A number of the other guidelines that go into that process are spelled out in greater detail in my statement.

I think that provides at least a more focused and more compact answer to the questions and I would be happy to answer the subcommittee's questions at this time.

[The prepared statement follows:]

STATEMENT OF H. DAVID ROSENBLOOM, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee. Thank you for inviting me to participate in a panel discussion today. I am grateful for this opportunity to discuss United States policy regarding tax treaties.

The questions raised in your letter inviting my testimony included: what the tax treaty policy of the United States is; what it should be; how that policy is formulated; and whether the policy should be different for developing, developed, and tax haven countries. In addition, you asked me to comment on a number of specific aspects of the process of formulating and implementing tax treaty policy.

These questions are very far-reaching.

Tax treaties represent a highly developed area of international cooperation. Few fields come to mind in which international groups have worked so consistently for so long. The model treaties produced through these efforts—by, for example, the Organization for Economic Cooperation and Development—constitute major achievements. Indeed, one is tempted to address your questions by referring only to the treaty materials that exist today, including the U.S. model treaties, and to review outstanding policy issues simply by comparing models and discussing their differences.

The existing models do not, however, speak to the question of what tax treaty policy might be. Because they reflect more than a half century of experience among nations, the models tend to assume answers to some fundamental questions.

These fundamental questions are: What is the purpose of tax treaties? Are bilateral treaties the optimum means of carrying out those purposes? Is the basic approach employed by existing models the best form of bilateral agreement?

A serious review of United States tax treaty policy must begin with these questions. For this reason, the first part of my statement describes the history of international efforts to achieve "tax harmonization." This part ends with a summary of the highlights of the OECD model income tax treaty, which forms the essential basis of current United States tax treaty policy.

The second part of my testimony focuses upon the United States experience: our treaties currently in force; the present U.S. model income tax treaty and its differences from the OECD model; and the major "collateral" issues which are of significance in current negotiations. Because most of the Subcommittee's questions relate primarily to income tax treaties, I will not discuss estate and gift tax treaties. I note, however, that significant activities are under way with respect to such treaties.

In concluding, I will discuss the overall "management" of the tax treaty program: the process of designing and modifying the U.S. model; how countries are selected to negotiate with; the "bargaining" process involved in treaty negotiations; the implementation of a treaty once it enters into force; and the degree of public participation in the treaty process.

I. INTERNATIONAL EFFORTS TO ACHIEVE TAX HARMONIZATION

A. The antecedents

What we now call "direct" taxes—taxes imposed directly on income or property—did not come into widespread use until the late eighteenth and early nineteenth centuries. From the first, states imposed such taxes on a dual basis, sometimes taxing because of a relationship to the person (for example, because he was a resident of the state), sometimes taxing because of a relationship to the property or income (for example, because the property was located in the state's territory). This dual basis of taxation obviously created a potential for two states to claim a right to impose the same kind of tax on the same base. But in early times this did not generally pose a practical problem because international commerce was not highly developed and tax rates were relatively modest.

Double taxation was, however, a problem for states that were closely related by language, history, or custom, and for political subdivisions of the same state. Quite frequently in these situations, important commercial relations were threatened by direct taxes imposed on a dual basis. These situations thus give rise to the earliest forms of "tax harmonization" laws, and interstate or international tax agreements, particularly among the Germanic states of Central Europe in the late nineteenth and early twentieth centuries.

During and shortly after World War I, double taxation became a matter of worldwide significance. Rates of direct taxation, particularly income taxation, were increasing, as was the volume of international business. In the United States, this led to the enactment, in the Revenue Act of 1918, of provisions embodying a "foreign tax credit," which allowed a deduction from the U.S. income tax of the lower of the amount paid to a foreign government as an income tax or the U.S. tax attributable to a taxpayer's foreign income. In 1920, a conference of representatives of most members of the League of Nations recommended to the League's Financial Committee that it study international double taxation and recommended means of alleviating it.

In a 1923 report commissioned by the League, four economists, from the United States, the United Kingdom, the Netherlands, and Italy, discussed the economic consequences of international double taxation; the principles governing the competence of states to impose taxes on "international" property or income; and the application of those principles in developing technical means of eliminating double taxation. For the first point—economic consequences—the economists used the model of a tax imposed in an "origin" or source country which supplements a pre-existing tax imposed by the country of the investor's "residence." They concluded that the principal consequence of such a tax for preexisting investments was a diminution of the value of the investment, and thus a penalty on the foreign investor. With respect to new investments, the tax was not a "burden" on the investor, since it would be discounted in making the investment and the investor could, if necessary, forego the investment altogether. Rather, the "penalty" was ultimately on the source state itself, or its consumers; the tax would raise the rate of return that an investor would demand before investing in that state. The "double" tax was, in effect, a protective tariff on the import of capital into the source state.

In regard to international competence to tax, the economists described two broad principles of modern direct taxation: "ability to pay" and "economic allegiance." The first point was simply that taxpayers should bear their share of the burden of government revenue needs in proportion to their ability to pay. The problem posed by this concept in an international context was identifying the group of persons whose "ability to pay" should be taken into account in allocating tax burdens. The economists concluded that this group should comprise those persons who owed the taxing power "economic allegiance" with respect to the property or income being taxed.

Four "elements" of economic allegiance were identified: where wealth originated; where wealth, once produced, was kept; where laws created or protected enforceable rights to wealth; and where wealth was consumed, disposed of, or enjoyed. The economists then discussed the implications of "economic allegiance" for the rights of states to tax different categories of wealth or income.

With respect to wealth derived from land, the state where the land was located was the dominant factor in production; the land, of course, remained in the source state; that state's laws ordinarily protected rights to land; therefore that state as opposed to the state of the owner's residence, had a predominant right to tax;

With respect to wealth derived from business property having a fixed location, and from personal property having a close relation to land, the considerations were similar to those involved in the case of land; therefore, the analysis favored the right of the source state to tax;

With respect to wealth derived from tangible personal property not closely tied to land, source of situs often played little part in the value of the property, and was in fact often determined arbitrarily; the state of the owner's residence, the state where the property presumably was enjoyed and which was usually also the state where rights in the property were enforced, enjoyed a predominant claim to "economic allegiance";

With respect to wealth derived from a category of property identified as "corporeal moveables not ordinarily capable of a fixed location"—principally ships—the dominant claim to tax was ascribed to the state of registry, on the ground that that was the state which enforced property rights; the state of source often could not be identified;

With respect to wealth derived from intangible property, considerations similar to those with respect to tangible personal property prevailed; these supported the primacy of the residence state, except in the case of real property mortgages, which were deemed akin to land;

With respect to earnings and salaries, the residence state had virtually sole claim to "economic allegiance."

The report discussed four methods of avoiding double taxation. The first would unilaterally concede the primary right to tax to the source state. The second would concede exclusive taxing authority to the residence state, through exemption in the state of source. The third was a "proportionate division" method—dividing taxes between two states according to some predetermined formula. The fourth method was "classification and assignment"—classifying income according to type, and assigning primary rights to tax certain types of income to one state and other types to the other.

In formulating recommendations, the economists ruled out methods which accorded primary or exclusive taxing rights to the source state, largely on the ground that this would be contrary to modern progressive taxation based upon an "ability to pay" principle. Approaches based on proportionate division and classification and assignment were also rejected, because the economists judged the theoretical problems involved in these approaches to be too great. Their preference was for the second method—exemption by the source state of the income of nonresidents—both because it avoided theoretical complexities and because it accorded with what they viewed as economic reality: The source state should cede the right to tax when it sought investment from abroad. To the objection that this method would create an unbalanced treatment of "creditor" and "debtor" countries—the method would involve a substantial revenue sacrifice by the latter—the economists responded with a proposal to divide revenues based upon the relative magnitude of different types of income deemed to have originated in each state. The taxpayer would not be affected.

In 1925, a Committee of Technical Experts organized by the League issued a further report on problems of double taxation. This report distinguished between "impersonal" taxes—schedular taxes or taxes imposed on different types of income—and "personal" taxes, that is, global taxes imposed on total income. With respect to personal taxes, the experts recommended that the state of residence be accorded a right to impose a tax on all income. They further suggested, however, that the state of source also be assigned a right to tax income from real property, and income from agriculture, commercial, and industrial undertakings. When such dual taxation occurred, "relief" would be given in the form of a reduction of tax, calculated according to prescribed formulae, in the state of residence.

The report of the Technical Experts also addressed, for the first time, the problem of international tax evasion. On the basis of the few existing arrangements between countries, the Committee concluded that "exchange of information in taxation matters" represented the best approach to combatting such evasion.

In 1927 the Technical Experts issued the first international draft model treaties: a model income tax treaty, a model covering succession duties, and a model governing administrative assistance in the collection of taxes. These were followed in 1928 by five models issued by a General Meeting of Government Experts convened by the League to discuss the 1927 models. Three of these 1928 models were separate income tax models—one for use between states which employed both "personal" and "impersonal" income tax systems; a second for use between states wishing to cover only "personal" tax systems; and a third covering exclusively "impersonal" tax systems.

The 1928 models provided the framework for the negotiation of a wide network of tax treaties, particularly among European nations. The models also served as a framework for the earliest United States tax treaties.

From the foregoing review it is clear that what I have referred to as the fundamental policy questions in the tax treaty area were addressed at an early date. The first question—what tax treaties are intended to achieve—was considered in the first report of the economists: double taxation represents an unfair burden on exising investment, and an arbitrary barrier, destructive of international economic welfare, to the free flow of international capital, goods, and persons. Nations should seek to eliminate—or at least alleviate—it.

The second question concerned the choice of bilateral approaches to eliminating double taxation. The early work of the League—particularly its sensitivity to the imbalance between "creditor" and "debtor" nations and its consideration of differences between "personal" and "impersonal" tax systems—revealed the justification for bilateral approaches. Multilateral agreement is difficult when countries are in different economic or legal circumstances. Unilateral measures, on the other hand, are almost inevitably ineffectual. After the first international models were issued, the Hoover Administration proposed modifications of the U.S. revenue laws under which the United States would have exempted income of any foreign person except realty and business income, if the foreign country of that person's residence granted reciprocal treatment. The idea was to avoid double taxation without separate international agreements. The measure was never enacted, but it is doubtful that it would have worked. Foreign investment by U.S. persons at the time was some four times greater than investment by foreign persons in the United States. Most countries would probably not have absorbed the revenue sacrifice involved by granting the "reciprocal exemption" envisioned by the bill.

Perhaps the most significant aspect of the League's work was its ultimate choice of "classification and assignment" as the basic structure for a model bilateral agreement. This structure is today universally used in virtually all tax treaties. While the League chose "classification and assignment" because of the differences between "debtor" and "creditor" countries, the approach has been used even between countries which believe that debts and credits between them are more or less in balance. The principal impact of this method is the need it imposes to classify and assign taxation rights, in negotiations, on an item-by-item basis.

In addition, the "economic allegiance" principle articulated in the League's work is the basis for most of the substantive rules—the actual classifications and assignments—in modern tax treaties. Real property income and income connected with a fixed business location are still the kinds for which a right to tax is most readily accorded to the source state. Passive investment income remains the kind which under international practice is most commonly reserved to the owner's state of residence.

B. The work of international organizations since 1928

At the conclusion of its work, the General Meeting of Government Experts recommended that the League appoint a permanent Fiscal Committee to monitor the development of an international network of tax treaties. The most significant product of this Committee's early work was a model treaty approved in 1934, governing the attribution of profits among different components of an integrated enterprise operating in different states. This model set forth for the first time as an international standard the so-called "arm's length" principle—that profits should be attributed to different components as if the components were separate enterprises dealing with each other at arm's length.

In 1943, the Fiscal Committee sponsored meetings in Mexico City which drafted new international models governing income taxes, estate taxes, and administrative assistance in collection. These "Mexico models" were substantially more detailed and precise than the 1928 models.

In 1946, the Fiscal Committee held another series of meetings in London; a model income tax treaty similar in structure and substance to the 1943 Mexico model, but more refined still, was drafted. Rules governing the double taxation of capital were introduced.

In 1956, acting at the urging of the international business community, the Organization for European Economic Co-operation (OEEC)—an entity devoted to the study and resolution of interstate economic problems facing European nations—formed a Fiscal Committee and charged it with the task of exploring the possibility of achieving a uniform multilateral treaty for the avoidance of double taxation. In its first report, in July 1958, the Fiscal Committee recognized that the task of preparing a multilateral treaty was "necessarily a long-term work"; it proposed first to issue a series of articles aiming at a "Model Bilateral Convention acceptable to all Member countries."

The Fiscal Committee proceeded to issue 30 articles in five installments, which were then collected as a model treaty in 1963. Meanwhile, in 1961, the OEEC was reconstituted as the Organization for Economic Co-operation and Development (OECD), with the addition of the United States and Canada. Other developed non-European countries, including Japan, Australia, and New Zealand, have since joined the organization.

The 1963 OECD model income tax treaty was accompanied by lengthy and elaborate commentaries which explained particular provisions. The commentaries also indicated matters not addressed in the model which might be covered in particular negotiations; the relationship of the model to the London and Mexico models, as well as the early work of the League; and the relationship of the model to prevailing practices of member states.

The OECD followed this work with the publication in 1966 of a comparable model estate tax treaty. In August 1977, the OECD issued a revised Model income tax treaty, with revised commentaries, both updated in light of the experience of member and nonmember states in working with the provisions of the 1963 model. Currently, the OECD is endeavoring to revise the 1966 estate tax model, to incorporate in that model provisions with respect to gift taxes, and to produce a new model governing reciprocal administrative assistance in tax matters.

The OECD efforts were principally directed to tax treaty negotiations between developed countries. Shortly after completion of the first OECD model, the United Nations Economic and Social Council instituted efforts to develop principles for negotiations between developed and developing countries. In 1967, the Council adopted a resolution expressing the view that tax treaties between developed and developing countries could serve to promote the flow of productive investment to the latter, and noting that, despite the widespread proliferation of treaties between developed countries, there were still very few treaties between developed and developing countries. The Council therefore requested the Secretary General to establish an ad hoc group of experts to study the problem of tax treaties between developed and developing countries, and to recommend guidelines for the negotiation of such treaties.

The experts came from both developed and developing countries. They are recommended by their governments, but serve in their private capacities, rather than as representatives of their governments. Since 1968, the group has met on a regular basis, and has issued eight reports on its work to the Secretary General; the reports provide a comprehensive discussion of the kind of problems raised by developed-developing country treaties. In 1974, the group issued preliminary guidelines for negotiations, which were superseded in 1979 by the issuance of a manual containing a new set of guidelines. The group intends in the near future to issue a model developed country/developing country treaty, representing a refinement of the guidelines set forth in the 1979 manual.

C. The 1977 OECD model

The OECD model can best be described for present purposes by a brief summary of its principal categories of rules.

Taxes Covered.—All income taxes of the contracting states are covered, including taxes imposed by local authorities and political subdivisions. Capital taxes are also covered, and a separate article is devoted to such taxes.

Personal Scope.—Coverage extends to residents of one or both of the contracting states. It does not generally extend to cases where both states claim a right to tax on a source basis, or to cases where one state taxes on the basis of citizenship.

Source basis taxation of income from real property and permanent establishments.—The OECD model retains the League principle that the source state should have the right to tax real property income. However, the model assimilates mortgage income to interest, not real property income. The model also allows a source state to tax business income fully if such income is attributable to a permanent establishment in the source state. This rule also descends from the early League work, but is now subject to exceptions which have evolved other time; moreover, there are special provisions for cases where business is conducted through an agent, providing for insulation from source basis taxation where the agent is independent and for such taxation when the agent is dependent but conducts significant business on behalf of the enterprise. The allocation rules used in these provisions explicitly rely upon the "arm's length" principle. A special exception for international transportation income grants exclusive taxation rights to the state where the "center of effective management" of the enterprise is located.

Passive investment income.—With respect to dividends and interest, the OECD model adopts the device of a limited or partial right to tax at source. Dividends may generally be taxed by the source state at a rate no higher than 15 percent; if, however, the payee is a corporation controlling more than 25 percent of the capital of the payor, the dividends are taxable at a maximum 5 percent rate. This special reduction is designed to harmonize with features of the laws of many states giving relief from double corporate level taxation for intercorporate distributions. The interest article reserves to the source state a right to tax at a rate no higher than 10 percent of the interest payment. The royalty article provides for reciprocal exemption of royalties at source.

With respect to capital gains, the model generally reserves the right to tax to the state of residence, with the exception of property closely associated with the source state—land and permanent establishment business property. Taxation of gains from the disposition of ships and aircraft used in international operations is reserved to the state in which the centre of effective management of the enterprise is located.

Personal service income.—The general rule in the OECD model is that personal service income is taxable in the state where the services are performed; but there are also a variety of special rules. With respect to "dependent" services, the state of residence has exclusive taxing rights as long as the taxpayer was present in the other state for less than half of the taxable year, and was not working under conditions such that the other state would likely be obliged to allow a deduction for his salary. "Independent" services, on the other hand, are taxable only to the extent they are connected with a "fixed base" in the source state—a concept which parallels the permanent establishment criterion used for determining when business profits may be taxed at source. Directors' fees are taxable in the source state—that is, the state of the paying corporation's residence. Artists' and athletes' income is invariably subject to taxation in the state where the personal services are rendered; and if the income from such services is deflected to another person, that person may be taxed in the source state without regard to whether it has a permanent establishment or fixed base there. Pensions are taxable only in the state of residence; income from government service generally in the state paying the income; and a special provision exempts payments to students for their maintenance, education, or training.

Nonclassified income.—The OECD model ultimately recognizes the primacy of the residence state in two ways. First, unclassified income, not specifically covered in the model, is taxable exclusively by that state. Second, a residual right to tax is generally accorded to the state of residence, even when the primary right to tax is granted to the source state. The residence state is required to bear the burden of eliminating double taxation for any income assigned to the source state; but it may tax the income in full if the source state does not tax it, or does not tax it at a level equal to that of the residence state.

Methods of avoiding double taxation.—The OECD model provides for alternative methods of avoiding double taxation. The first, the "ordinary credit" method, is patterned on the United States foreign tax credit provisions. The residence state allows a reduction of its tax for the tax paid the other state, but is not required to allow a greater reduction than an amount bearing the same proportion to its total tax as the amount of income which the source state is allowed to tax bears to the taxpayer's total income. The second method, "exemption with progression," requires the residence state to exempt the income which the source state may tax, but permits the residence state to determine its tax on remaining income by a progressive schedule which takes account of the income taxable by the source state.

Nondiscrimination.—This provision forbids states from discriminating against nationals of the other state in tax matters—it guarantees the principle of "national treatment." Nondiscrimination provisions were common in tax treaties from an early period, but the 1963 OECD model introduced two novel forms of such provisions. The first forbids discrimination against a "permanent establishment" of a national of the other state. The second forbids discrimination against an enterprise based on the fact that its capital is owned in substantial part by nationals of the other state.

Exchange of information.—The OECD model contains relatively liberal exchange of information provisions, which, however, include limitations deriving from the early work of the League: the restriction to informaiton in the requested state's possession, or available under its laws; and a guarantee that a requested state need not take steps contrary to its security, sovereignty, or public policy.

Mutual agreement procedure.—The model provides a mechanism for the resolution of disputes; each state designates in the treaty a "competent authority" who serves as its representative for interpreting and implementing the treaty. The model provides for consultation among competent authorities, but does not require that they come to an agreement, nor does it provide any mechanism for binding them to a decision. The procedure is supplementary to procedures, including recoures to courts, which are available to a taxpayer under domestic law.

II. UNITED STATES TREATY POLICY

A. Existing United States Treaties

The United States presently has 30 independently negotiated income tax treaties in force. Several of these have been extended to territories of the treaty partner, and in some instances these territories have since become independent and assumed their obligations under the treaty. While a comprehensive review of U.S. treaties is not possible here, a general survey may be useful.

In part because U.S. treaties have been heavily influenced by the international models outstanding at the time of their negotiation, and in part because they have been influenced by developments in domestic law, the treaties tend to follow patterns corresponding to the periods when they were negotiated. Roughly speaking, there are four principal "periods."

The first general U.S. tax treaty—after certain limited purpose treaties, chiefly governing the taxation of shipping profits—was with France, signed in 1932. The principal purpose of this treaty was to mitigate the broad territorial reach of French taxation of U.S. business enterprises operating in Paris. The treaty did not deal generally with many of the subjects covered by the 1927–28 League models. It contained rules governing only income from government service; war pensions; private pensions and annuities; royalties; and business profits. The treaty contained no provisions concerning administrative cooperation or exchange of information; and none governing nondiscrimination.

Much broader was a treaty signed by the United States with Sweden in 1939, and a new treaty signed in the same year with France. The Swedish treaty was ratified in 1940, but the French treaty, which replaced the 1932 treaty entirely, was not ratified until the end of the Second World War. In these two treaties, the United States established some important principles which have remained cornerstones of U.S. tax treaty policy. The first was that the tax treaties should not generally affect the taxation by the United States of its citizens and residents. The second was the emphasis given to administrative cooperation, particularly exchange of information. The United States system of collecting income taxes depends heavily upon an ability to collect information at source on payments of income, and sometimes to collect taxes at source; and our ability to obtain information concerning a persons' financial activities from third parties. In the Swedish and French treaties, the United States recognized the special importance to us of obtaining access to information at source when the source was in another country.

In 1942, the United States signed a general treaty governing double taxation and administrative cooperation with Canada. This treaty differed from the 1939 treaties with France and Sweden in that it covered generally items of investment income; the French and Swedish treaties did not apply, in particular, to interest income.

These treaties—with France, Sweden, and Canada—represent our "early period" conventions. The 1939 treaty with France was superseded by a new treaty signed in 1967, which itself was subject to substantial revision by 1970 and 1978 protocols. The 1939 Swedish treaty was substantially revised by a 1960 protocol, but the treaty signed in 1939 is still in effect, and is our oldest. The 1942 Canadian treaty was substantially revised in 1950; but it, too, is still in effect.

The "second period" of U.S. income tax treaties was inaugurated with the 1945 treaty with the United Kingdom. This treaty generally covered items of passive investment income—interest, royalties, dividends, capital gains—but distinguished among particular categories of such income. Notably, it provided for exemption of interest from tax at source. The treaty was regarded as a major advance for the United States because of the United Kingdom's acceptance of broad exchange of information and administrative cooperation provisions. This treaty was substantially revised by a protocol negotiated in 1966, and ultimately was replaced by a new treaty signed in 1975, which, with one exchange of notes and three protocols, entered into force just four days ago. The original treaty remains in force, however, with approximately fifteen jurisdictions with respect to which it was extended, with modifications, in 1958.

The first United Kingdom treaty established a model for U.S. treaties negotiated between the end of World War II and the commencement of double tax treaty work by the OEEC and, later, the OCED. During this period we negotiated treaties with most of the states of the developed world, including twelve treaties with European countries (the United Kingdom, the Netherlands, Denmark, Norway, Ireland, Greece, Switzerland, Italy, Germany, Austria, Finland, and Belgium); four with non-European developed countries (South Africa, Australia, Japan, and New Zealand); and one with a developing country (Pakistan). The treaties with Japan and Finland were superseded by new treaties in the early 1970's. The treaties with the United Kingdom and Belgium were also superseded insofar as the developed country treaty partner is concerned, but remain in force with respect to territories or former territories of those countries. And several other treaties of this period have been substantially revised by protocol.

The treaties negotiated in this general period cover the basic range of subjects in the present OECD model and the present U.S. model, although there are omissions in some of them. But the content of some of these treaties often differs from what we would seek today. Among these differences the most important concerns the typical "business profits" article. Before 1966, domestic law made the United States a "force of attraction" jurisdiction—that is, if a foreign person was engaged in trade or business in the United States, all his U.S. source income was subject to tax, regardless of whether the income was attributable to the business; and we taxed none of that person's foreign source income even if, in an economic sense, such income was attributable to the U.S. business. In accordance with this statutory law, most of our treaties from this period provided that permanent establishments could be taxed in a source state on, and only on, income arising in the source state. When we changed our law in 1966, in addition to relieving non-"effectively connected" income from U.S. tax, we also subjected to tax "effectively connected" income having a foreign source. The existing treaties undermine the current statutory pattern of taxation, because by statute we no longer tax the non-effectively connected U.S. source income—even though we have the right to do so by treaty—while the treaties preclude us from applying our domestic law to tax effectively connected income of foreign source.

Most of the treaties of this period allow a person earning real property income in the United States the right to elect annually to be taxed on a "net basis"—i.e., at progressive rates and with deductions—rather than at the gross (30 percent) rate applicable in the absence of an election. The Internal Revenue Code has permitted such an election since 1966, but that election is irrevocable unless consent to change is given by the Internal Revenue Service. Treaty provisions permitting the election to be made on an annual basis create certain tax avoidance opportunities for persons investing in U.S. real property.

Most of these treaties also concede the right of the United States to impose its "second dividend" and "second interest" taxes—the taxes we apply to dividends and interest paid by foreign corporations doing substantial business in the United States. Most contain personal service articles different in significant detail from those we would seek today; few contain the special provisions now included in U.S. treaties governing the earnings of artists and athletes. Most have exchange of information and mutual agreement provisions that are more restrictive than we like to negotiate now. Most have imprecisely drafted provisions governing the mechanism for crediting "source country" taxes. Most contain provisions conferring benefits upon teachers, which we no longer view as appropriate. Although many of these treaties have been modified by subsequent protocols or new treaties, many outdated provisions continue in force.

This "second period" of the U.S. tax treaty program also witnessed the entering of a tax treaty relationship with smaller countries. Under the Mexico and London models, a treaty could be extended to territories of one of the parties by notice given through diplomatic channels to the other party. Our 1945 treaty with the United Kingdom contained such a "territorial extension" provision, as did several other treaties signed shortly after World War II. In the process of seeking ratification of those treaties, however, understandings were reached between the Executive Branch and the Senate Foreign Relations Committee that no such extension would be effected without separate ratification of each extension by the Senate. In 1955, pursuant to a request by the Kingdom of the Netherlands, the United States for the first time extended a tax treaty to an overseas territory of a treaty partner; the Netherlands Antilles. In 1957, the Belgian treaty was extended to three Belgian territories which are now Rwanda, Burundi, and Zaire. In 1958, the United Kingdom treaty was extended to 20 overseas territories of the United Kingdom.

At the same time, the United States, under the Eisenhower Administration, inaugurated a program of negotiating tax treaties which included a "tax sparing" provision. Many developing countries have, in the past and at present, relied upon special tax incentive legislation to attract foreign investment. The idea of "tax sparing" developed in the 1950's; under this concept, a developed country would agree by treaty to give a credit not only for taxes imposed by a developing country, but for taxes which would have been imposed in the absence of tax holiday legislation. This idea won widespread support among business groups interested in the double taxation problem, such as the National Foreign Trade Council and the International Chamber of Commerce.

When the first U.S. treaty with such a provision—the treaty with Pakistan—was submitted to the Senate for ratification, the "tax sparing" idea was greeted with hostility by the Foreign Relations Committee. The Senators emphasized the traditional view of U.S. tax treaties—that they did not reduce or affect the tax burdens of United States persons—and that tax sparing was obviously a departure from this principle. While the Pakistan treaty was under consideration, however, Pakistan repealed its tax incentive legislation, which mooted the treaty provision. Nevertheless, the Committee, in reporting the treaty favorably, entered a reservation to the tax sparing provision, and the treaty was approved by the Senate subject to the reservation. Three other treaties with tax sparing provisions—with India, the United Arab Republic, and Israel—were never reported out by the Committee.

The third group of U.S treaties comprises those 12 treaties in force that were negotiated since 1960, but prior to publication of the U.S. model treaty in 1976. Of these, six (Luxembourg, France, the United Kingdom, Japan, Belgium, Iceland, and Finland) are with OECD countries; two (Korea, Trinidad & Tobago) are with Free World developing countries; and three (the USSR, Poland, and Romania) are with Communist countries. In addition, the United States during this period negotiated significant protocols to some of the earlier treaties—notably those with Germany, Sweden, and the Netherlands.

Several features distinguish these treaties from those of the prior period. With the exception of the quite unusual treaty with the USSR, these treaties tend to follow closely the structural format of the international model; but they contain special provisions, found neither in the earlier treaties nor in the OECD model, reflecting a unique approach by the United States. The most important of these provisions are those dealing with "general rules of taxation" and source of income. The general rules of taxation provide, typically, that the treaty is not to restrict any allowances, credits, or deductions permitted under domestic law; and that a contracting state is permitted to tax the income of a resident of the other contracting state only to the extent that income is from sources within the first state. The source provision includes detailed rules governing when income is deemed to arise in the source state; these rules, which typically expand to some extent upon the "source" rules set forth in the Internal Revenue Code, are designed to guarantee that the classification and assignment of substantive taxing rights will avoid double taxation in practice.

This "third period" of U.S. tax treaties saw another significant development in regard to U.S. tax relations with developing countries. Under the Kennedy and Johnson Administrations, the Treasury did not negotiate treaties with "tax sparing" provisions, because it viewed those provisions as creating an artificial bias in favor of foreign investment over domestic investment. In 1962, however, Congress adopted a statutory investment tax credit which, by its terms, was available only for investments in property placed in service in the United States. The Treasury, by treaty with developing countries, agreed to allow a similar credit for property placed in service in the developing country treaty partner, and treaties containing such provisions were signed with Thailand, Brazil, Israel, and the Philippines. This provision, too, was found unacceptable by the Foreign Relations Committee, which viewed the investment tax credit as designed to spur domestic investment and domestic employment, and which regarded it as inappropriate to extend the measure by treaty to stimulate foreign investment. Of the treaties which contained an investment tax credit feature, the Committee reported only the one with Brazil, subject to a reservation on this point; the Senate approved the treaty subject to the reservation, but the treaty never entered into force.

The fourth group of U.S. treaties are those based more firmly on the 1976 U.S. model and the revised version of that model published in 1977. Only one treaty currently in force, with Hungary, falls in this group. But there are numerous treaties currently in the process of negotiation, translation, signature, or ratification that would fall in this group as well.

A. The U.S. Model

The point of reference for all United States income tax treaty negotiations undertaken today is the U.S. model income tax treaty, which follows the OECD model in most important respects. Issued publicly for the first time in December 1976, the model was reissued, with realtively minor modifications, in May 1977. Although some U.S. negotiating positions have changed since 1977, a new version of the model has not yet been issued. We attempt to take developments into account in actual negotiations.

The most important differences between the U.S. model and that of the OECD are as follows:

Citizenship basis taxation.—The OECD model applies only to states which tax globally on the basis of domicile or residence. We, of course, tax on a citizenship basis in addition to a residence basis. We regard it as appropriate to attempt to relieve double taxation which occurs when a nonresident U.S. citizen is taxed on a source basis by a treaty partner. In addition, the U.S. model contains a "saving" clause permitting taxation of U.S. citizens (including former citizens) as if no treaty were in effect. Since this rule is overbroad in certain respects, it is necessary to accompany the saving clause with specific exceptions.

Coverage of state and local taxes.—Under the U.S. model, state and local income taxes are not covered, except for the nondiscrimination article. The OECD model provides for general coverage of the taxes of a political subdivision or local authority.

Corporate residence.—The United States treats place of incorporation as the test of corporate residence, and the U.S. model reflects this statutory rule. Some other countries use a "managed and controlled" test. The OECD model provides that when a corporation is, under the domestic law of the contracting states, deemed a resident of each state, its residence is determined by the place where its "effective management" is situated. The U.S. model resolves such cases on the basis of place of incorporation.

Interest exemption.—The U.S. model contains a reciprocal exemption of interest at source. The OECD, in contrast, grants a right to the source state to tax at a rate not in excess of 10 percent.

Investment or holding companies.—The U.S. model contains a provision not found in the OECD model, denying reductions of source basis taxation when a corporation of the other state is largely owned by nonresidents of that state and benefits in that state from special tax measures. This provision, which places the United States at the forefront of the international effort to prevent treaty abuse, requires further thought and refinement.

Elimination of double taxation.—The U.S. model contains detailed provisions for relief from double taxation, and an explicit assurance of a foreign tax credit for taxes covered. Source rules are provided to permit the classification and assignment of substantive taxation rights to operate effectively. The model does not extend relief for the deemed paid credit below the first foreign subsidiary.

Beyond these fundamental differences between the models lie a wide range of other differences. Some are merely matters of style, although an effort has been made to minimize differences without substance, for the sake of facilitating negotiations. An additional list of significant points in the U.S. model would include at least the following:

Penalty taxes.—The model does not cover the accumulated earnings tax and the personal holding company tax. We wish to ensure that United States persons do not evade these penalty taxes through the formation of corporations in treaty countries.

Excise taxes on insurance premiums and private foundations.—The U.S. model covers these taxes, on the theory that they are, in effect, imposed in lieu of income taxes. In cases where the other country has similar taxes, we would insist upon reciprocity.

Coverage of taxes for non-discrimination and exchange of information provisions.—The U.S. model covers all taxes, including state and local taxes, for purposes of the non-discrimination article. It covers all national level taxes for purposes of the exchange of information article. The first of these provisions represents a strong United States position against discriminatory tax measures. Since there is a long tradition in the United States of state adherence to standards of non-discrimination, we attempt to secure comparable coverage by the treaty partner. With respect to exchange of information, we believe that since a treaty relationship is to be established, the broadest possible provisions for information exchange are desirable; but even if this notion is unacceptable to the treaty partner, at a minimum we wish to obtain sufficient information to permit the treaty to operate, even if the information was obtained by the treaty partner under a national level tax not generally covered by the treaty.

Trusts and partnerships.—Unlike the OECD model, the U.S. model contains rules ascribing a state of residence to trusts and partnerships. These rules are intended to permit the treaty to operate in circumstances that are relatively common in United States practice.

Remittance basis.—Reductions in source basis taxation are generally not justified in the face of rules in the residence state preventing taxation of the benefited income. Many countries—particularly countries previously forming part of the Commonwealth of the United Kingdom—provide by law that residents will not be taxed on income which is not remitted to the country. The U.S. model denies reduction in source basis taxation in such circumstances.

Construction projects.—The model provides that a construction project will not be considered a permanent establishment, and thus subject to taxation at source, until it lasts for more than 24 months in the source state. This provision reflects the U.S. position as a net exporter of construction services. The comparable OECD provision is 12 months; the UN model prescribes a period of 6 months.

Net basis election for real property.—The U.S. model, reflecting statutory law, permits a taxpayer to elect to be taxed on real property income on a net basis. This rule is included in the model to ensure that the other state will allow similar net basis taxation. We are prepared to delete this rule when we are satisfied, through negotiations, that the statutory law of the other state permits such taxation.

Allocation of expenses to permanent establishment.—The U.S. model contains more detailed rules than the OECD model governing the allowance of deductions in the source state for expenses borne by a home office on behalf of the entire enterprise. This provision is designed to reflect United States rules governing allocations of expenses to foreign source, as opposed to domestic source, income.

Definition of business profits.—The U.S. model contains a rule defining business profits, and making clear that rentals of tangible personal property and income from the licensing of films and broadcasting rights come within the definition. We seek a definition of business profits because the OECD model is ambiguous in regard to certain kinds of income. We prefer to classify film and broadcast income, and income from the leasing of tangible property, as business income, because this classification ensures taxation at source, if there is to be such taxation, on a net basis. The expenses associated with these kinds of income can be high. In contrast, the OECD model classifies these types of income as royalties, but provides for exemption at source.

Expanded definition of shipping and air transport income.—The U.S. model expands the concept of income from international shipping and air transport to cover the rental of ships, aircraft, and containers used in international transport. We believe that the income from such activities is essentially similar to income from international shipping and air transport, and that the policies dictating a separate provision for the latter types of income apply equally to the former.

Direct investment dividends.—The U.S. model provides for a maximum rate of 5 percent for source basis taxation of dividend income derived by a corporation owning 10 percent or more of the voting stock of the company paying the dividends. The comparable rule in the OECD model provides for a maximum 5 percent rate when the payee corporation owns 25 percent or more of the capital of the company making such payments. The U.S. preference for a 10 percent ownership test is designed to mesh with U.S. statutory law governing the deemed paid foreign tax credit.

Second withholding taxes.—The U.S. model permits the United States to impose its "second withholding taxes" on dividends and interest paid by a foreign corporation deriving income from the United States. These rules are particularly important in negotiations with a country having a "branch profits" tax.

Royalties.—The U.S. model provides that royalties include gains contingent on the productivity, use, or disposition of rights or property. This rule corresponds roughly with U.S. statutory law.

Capital gains on the disposition of shares in a real property holding organization.—This is one respect in which our current negotiating practice deviates from the model. Under both our model and the OECD model, a source country may tax capital gains on real property. But an investor may avoid source state taxation by incorporating a holding company to own the property. This device will not insulate operating income from current taxation, but it may be effective for avoiding source taxation of capital gain on sale of the shares, which may well reflect appreciation in the value of the underlying property.

United States statutory law does not generally tax foreign investors on gains from the disposition of shares in corporations formed to hold real property. In connection with the Revenue Act of 1978, however, legislation was proposed which would have taxed gains from the disposition of shares in a company formed to hold U.S. farmland. In the 96th Congress, more far-reaching legislation has been introduced which would tax foreign investors on their gains from the disposition of shares in real property holding organizations—entities formed to hold any U.S. real property. The legislation has had broad congressional support; and the Treasury has supported the general idea behind it.

In the face of these developments, we have modified our treaty policy and now seek a provision granting reciprocal rights to source state taxation of capital gains on the sale of shares in corporations formed for the sake of holding real property situated in that state.

Independent personal services.—The U.S. model allows source basis taxation when a person is present in the source state for more than half of a taxable year. This provision, which derives from U.S. statutory concepts, is similar to the dependent personal services provisions in both the OECD and the U.S. models. It is intended to supplement the "fixed base" rule which the OECD model uses exclusively for independent services and which is sometimes difficult to administer.

Directors' fees.—The U.S. model contains no separate article on this subject, reflecting the view that directors' fees should be taxed as independent personal services or dependent personal services, as the case may be. Many other countries have special statutory rules for directors' fees, because such fees are not deductible by the paying corporation. They are, in effect, considered a distribution of corporate profits.

Artists and athletes.—The OECD model provides that the state where services of an artist or athlete are rendered may tax the income from such services without limit. It also provides that where income from such services is diverted to another person, the source state may tax without regard to the existence of a permanent establishment or fixed base. The U.S. model, in contrast, contains a "threshold" limiting source state taxation when an artist or athlete has not received remuneration in excess of $15,000 in the taxable year. It also limits the special rule on source state taxation of diverted income to cases where the performer has an interest in the recipient entity.

Social Security payments.—The OECD model reserves to the residence state the right to tax pensions, including benefits paid from a public social security fund. The U.S. model provides for exclusive taxation of social security and other public pensions at source. Since the United States does not tax Social Security benefits, and has geared benefit levels accordingly, we seek to ensure that our benefit structure will not be impaired by taxes imposed by the other state.

Annuities, alimony, and child support.—The U.S. model contains specific provisions, missing from the OECD model, to deal with these items of income. With respect to annuities and alimony, the U.S. model provides for exemption in the source state. With respect to child support, the model—reflecting U.S. statutory law, which does not provide for taxation of such payments—provides for exemption in both states.

Government service.—The U.S. model follows the OECD model in this article, except that it contains provides a rule treating the spouse or dependent child who begins to render government service after moving abroad like the spouse who moved abroad for the purpose of rendering such service. In addition, the U.S. model provides that a citizen rendering government service will generally be treated as a resident of the sending state for all purposes under the treaty.

Students.—The U.S. model provides an election for a student to be treated for tax purposes as a resident of the state in which he is studying. This provision is intended to permit the student to take advantage of statutory allowances and exemptions available only to residents. A person who makes such an election is required to pay tax on his worldwide income to the United States.

Non-discrimination.—The U.S. model covers discrimination against nonresidents but provides that, in effect, nonresident aliens will not be entitled to net basis taxation in the United States. In addition, the model provides a relatively detailed rule governing the allowance of indirect expenses as deductions in the source state. In these respects the U.S. model extends principles found in the OECD model. On the other hand, the U.S. model—unlike the OECD model—provides no protection against discrimination by the source state for corporations not having a permanent establishment in that state.

Mutual agreement.—The U.S. model provides for no time limit on the period in which a case can be presented to the competent authority, and spells out in detail some of the actions which are permissible for the competent authority to take. We think it helpful to provide as much guidance to the competent authority as possible. Many countries, which have more flexible competent authority mechanisms than the United States, do not perceive the need for such rules, which are not found in the OECD model.

Exchange of information and administrative assistance.—The U.S. model provision on exchange of information is broader than that of the OECD. It expressly requires a state of which information is requested to take depositions, and engage in other specified information-gathering activities, on behalf of the requesting state. The U.S. model is intended to produce information in a form that will be useable in U.S. courts. It also contains a provision requiring the residence state to collect taxes on behalf of the source state for the purpose of ensuring that relief granted by the source state does not inure to the benefit of persons not entitled to such relief. This feature is aimed at combating the use of nominees to secure unintended advantages under a treaty.

Territorial extension.—The U.S. model contains no provision like that of the OECD model governing territorial extensions. Since territorial extensions must be independently ratified in the United States, a territorial extension provision is of no effect and, indeed, can be misleading.

The U.S. and OECD models are, of course, blueprints for only the issues commonly faced in treaty negotiations. There are many treaty issues which do not fit within the confines of the models. These issues arise either from special features in the other country's law or in our own, or from the status of the treaty partner—as a developing country, for example. As might be expected, these are some of the most serious and controversial issues we confront.

Imputation systems.—In recent years a number of developed countries have modified their pattern of taxing corporate earnings in order to mitigate "double taxation" at the corporate and shareholder levels. This "integration" of corporate and shareholder taxation has taken a variety of forms. In some countries, distributed profits are taxed at a lower rate than undistributed profits. In others an "imputation" system is used. Imputation means that part or all of the tax charged to the corporation is allowed as a credit to the shareholder when profits are distributed as a dividend; the shareholder includes in income both the dividend and the amount of creditable tax, and claims a credit against his individual liability for the tax paid by the corporation.

Imputation itself has various manifestations. Some countries have adopted "compensating" taxes at the time of a distribution, or at the time of a distribution of previously untaxed profits, to ensure that the shareholder credit is funded by taxes paid by the corporation. Some countries allow shareholder refunds when the credit at the individual level exceeds the shareholder's tax liability. Some countries have combined split rate systems with an imputation feature. Some countries impute only a relatively small portion of corporate level taxes to the shareholder. Some countries maintain substantial residual taxes at the shareholder level. The variations on this theme are many and complex.

In most cases, however, imputation countries, by their domestic law, do not accord the shareholder tax credit to nonresidents. Nonresident shareholders are ordinarily taxed at a flat percentage of the dividend. Imputation systems thus first place our investors at a disadvantage, in terms of access to capital, by comparison with investors who are residents of the imputation country. We have sought in treaty negotiations to secure benefits for U.S. investors commensurate with the imputation benefits granted to source state investors. This may involve "imputation credits," or some substitute for them, for our residents who make equity investments in such countries. The issue gives rise to controversy and complexity in current negotiations.

Tax sparing.—A major issue, in negotiating with developing countries, concerns "tax sparing," the grant by the state of residence of a tax credit for taxes that would have been charged in the source state but are not because of special tax relief or "tax holiday" provisions. The position of developing countries is now as it was two decades ago—that tax holidays are in their national interest and that without tax sparing a credit country such as the United States—which allows the credit only for foreign taxes actually paid—counteracts the tax holiday legislation and itself collects the tax "spared."

We think it inappropriate to use tax treaties to favor foreign investment over domestic investment. Moreover, given the history of this issue, we believe that a treaty reflecting a different view would be unlikely to achieve ratification.

Source basis taxation in developing countries.—The OECD and U.S. models are, as indicated, designed primarily for treaties between countries where the flows of income and capital are roughly reciprocal. The limitations of source state taxation in those models produces a revenue cost for that state. However, when investment flows are more or less reciprocal, the revenue sacrifices more or less offset each other. In a treaty between a developed and a developing country the flows are largely in one direction: income flows from the developing country to the developed country. Thus, a model which is in form reciprocal in fact can impose a substantial revenue burden on a developing country. The UN guidelines, which contain a more expanded source basis of taxation, recognize the need of developing countries to conserve revenues. The shift is, however, tempered by the often conflicting need of developing countries to attract capital, an objective which is best served by limited source basis taxation.

Permanent establishment definition and business profits.—The UN guidelines include an expanded definition of the permanent establishment concept. It permits taxation by the source state if an enterprise maintains a stock of goods for delivery in that state; or if it has an agent there who regularly makes deliveries on behalf of the enterprise. It permits a limited "force of attraction" of non-attributable income at source. And it contemplates source taxation of a foreign enterprise engaged only in purchasing in the source state.

Shipping.—The UN guidelines contain an optional provision allowing source state taxation of shipping activity which is more than casual, even if that activity is conducted by an enterprise managed outside that state's borders.

Investment income.—With respect to dividends, interest, and royalties the UN guidelines provide for a positive rate of taxation at source, but do not fix the maximum rate; the participating developing countries believed the OECD rates—5 percent on direct investment dividends, 15 percent on portfolio dividends, 10 percent on interest, and zero on royalties—were too low. With respect to capital gains, the UN guidelines reserve the right of the source state to tax shares representing a substantial participation in a company engaged in business within that state.

Personal service income.—The UN guidelines treat managerial salaries as taxable in the state of a company's residence, regardless of where the managerial services are performed. They contain an option to allow source state taxation of pensions.

Other income.—The UN guidelines limit residual residence state taxation to income from sources in the state of residence or from third countries; the source state is permitted to tax residual income arising, under its own laws, in that state.

The United States has long recognized that items that would likely be exempt at source in a developed country treaty may be taxable at source in a treaty with a developing country. In negotiating with developing countries we have sought primarily to shift items that such countries might perfer to tax on a gross basis into net basis taxation, since we believe net basis taxation to be both fairer and more reasonable than gross basis taxation. These points, of course, imply a broadened definition of "permanent establishment" in treaties with developing countries, and this coincides with a basic thrust of the UN guidelines.

The United States has also been prepared to accept relatively low thresholds for taxation of services income at source. And we have accepted relatively high source taxation of passive income in developing country treaties, focusing more on the practical need to avoid excess foreign tax credits than on the theoretical preference for residence basis taxation of such income.

As a very general matter, therefore, many of the UN guidelines appear acceptable as they stand, or with relatively minor revisions. We intend to draw heavily upon them in producing internal guidelines for use in negotiations with developing countries.

Foreign tax credit.—In June 1979 the Internal Revenue Service issued proposed regulations setting forth standards for determining when a payment to a foreign government constitutes an "income tax," or a tax in lieu of an income tax, creditable against U.S. tax liability under the Internal Revenue Code. These standards would preclude credits in the case of certain taxes which are viewed, or at least labeled, as "income taxes" by the governments imposing them. The regulations have doubtless highlighted questions regarding the extent to which tax treaties should, and do, guarantee foreign tax credits for the taxes they cover. These questions are especially acute with respect to payments to foreign governments in connection with the exploitation of natural resources. It is our present policy to accord a treaty credit for covered taxes, and in some cases this implies a credit in cases where there may be doubt regarding the application of the statute. In such cases of doubt we believe the treaty credit should be limited so that it will have no effect for source state credits exceeding the tentative U.S. liability with respect to income arising in that state.

State taxation using the unitary apportionment method.—The "arm's length" method of apportioning profits among components of an integrated international enterprise has been the international standard since the 1930's. Within the United States, among states, a "unitary apportionment" method is still widely used. Many foreign countries have strongly objected to this method of state taxation when it is applied to foreign controlled corporate groups. They have argued that the method results in taxing more profits than are attributable to activities conducted within a state, and that it requires a burdensome amount of information about an enterprise's worldwide operations.

Third country use.—Most United States treaties allow benefits in the nature of reductions in source basis taxation to corporations organized in the treaty partner, regardless of whether the owners of the corporation are residents of, or are in any other way connected with, that country. Any treaty conceivably can, therefore, be used to effect an overall change in the incidence of United States taxation of U.S. source income, by the simple formation of a "holding company" qualifying for treaty benefits. If a person, for instance, holds equity securities subject to our 30 percent withholding tax on dividends, he can normally reduce that tax by organizing a corporation in a country with which we have a treaty reducing the rate to 15 percent.

In practice, however, this kind of "third country use" of tax treaties does not routinely arise, because it is ordinarily not cost-free to make investments through a holding company specially organized in a treaty partner. Most treaty partners of the United States will tax income received by the corporation, which ordinarily will eliminate any advantage from the reduction of the U.S. rate at source. To the extent the investor will be subject to withholding tax on payments from the corporation, or to the extent he is not able to claim complete relief in his home country for a dividend from a foreign corporation, the additional tax burden will often exceed the benefits achieved under the treaty with the United States.

This protection of the treaty process depends, however, on the existence of normal taxing provisions in the law of the treaty partner. Some of our treaty partners have special provisions granting privileges to holding companies, which result in reduced taxation of the holding company or reduced taxation on the payment of income from the treaty country to a third country. Sometimes this occurs for reasons of domestic policy, but sometimes the treaty partner has deliberately enacted provisions with the aim of attracting "offshore" business, with an eye to the revenues that can be collected from licensing fees or those taxes which are imposed; and to the service industry that can be built up around an "offshore" financing business.

In addition, treaties can be used to channel benefits to "third country" beneficiaries through the use of "conduit" companies. This practice depends upon an exemption from source basis taxation of payments from that country, and a hospitable attitude toward "offshore" business. The conduit company earns income in the United States which is subject, under the treaty, to reduced U.S. tax; the income is then siphoned off as payments deductible from the base subject to tax in the treaty partner, to the person who is the real investor.

These "treaty shopping" practices are objectionable for a number of reasons which I have previously described to this Subcommittee. The practices cause unintended revenue loss, not contemplated by the treaty "bargain." They may undermine the willingness of third countries to enter into treaty negotiations with us. And, perhaps most seriously, such practices are contrary to the spirit of international double tax treaties, and enhance opportunities for international tax evasion. Double tax treaties are, as I have mentioned, founded on the principle of allocating taxing rights based on "economic allegiance"; treaty shopping accords a revenue power to a third country, the "base country," which has little or no claim to such allegiance. In addition, since most "base countries" have local law provisions which ensure confidentiality of the identity of the ultimate investor, the conclusion is inescapable that the practices are employed to a large extent by persons evading taxes in their home country.

Within the last year we have initiated negotiations aimed at modifying three treaties which we believe present treaty shopping problems—with Switzerland, the Netherlands Antilles, and the British Virgin Islands. Our objective in these negotiations, generally, is to secure new provisions that will eliminate or materially reduce the potential for abuse.

There are potential statutory solutions to the "treaty shopping" problem. Congress could enact a law denying benefits under income tax treaties to corporations disproportionately owned by third-country interests, or to income used to a disproportionate extent to satisfy third-country claims. Switzerland has a law like that, but it is aimed at persons using Switzerland as a base country to derive income from countries with which Switzerland has tax treaties, not at persons earning income in Switzerland. Such legislation by the United States would require careful assessment. Statutory override of treaty bargains has a disruptive effect on our entire treaty program, if not on our foreign relations generally. Moreover, a blanket denial of benefits to corporations controlled by third country residents would undoubtedly cut too broadly since our principal difficulties stem only from a few treaties with countries which have chosen to foster an "offshore" business as a deliberate policy. Such legislation might deny benefits to arrangements having legitimate business purposes.

Coverage of possessions.—A number of our negotiations have raised the question of treaty coverage of U.S. possessions. At present, none of our treaties in force applies to any of the possessions. The possessions have income tax systems which are separate from the U.S. system, although the law in force in many of them is the Internal Revenue Code as "mirrored"; and in others, the law is closely patterned on our internal tax law. We generally believe that covering the possessions is a salutary idea, because it secures the protections of a treaty for possessions residents who wish to invest or otherwise earn income abroad, and it may contribute to increased investment in the possessions. However, under present law coverage of the possessions would, as a practical matter, require the negotiation of mini-treaties, and the possessions to date have not clearly expressed interest in undertaking such an effort.

C. Management of the treaty program

The questions of what U.S. tax treaty policy "is" and how it is formulated ultimately depend, of course, not only upon what the models or the treaties in force provide, or what view we take in the abstract about particular issues, but also upon our methods of conducting bilateral negotiations. This raises a host of questions about the "management" of the treaty program: how we formulate or revise provisions of the U.S. model; how we determine which countries we will negotiate with; how negotiations are actually conducted; and finally, how treaties in force are administered.

Design of the U.S. model treaty.—The most important decision that has been made in designing the U.S. model was to adhere as closely as possible to the OCED model. The discussion to this point indicates the basic justification for this approach; the OECD model represents an appropriate, if not perfect, theoretical basis for tax treaty negotiations; it evolved in a pragmatic way; and it offers the best chance of achieving the maximum degree of international tax harmonization, the reduction of tax-based barriers to the free movement of goods, persons, and capital across borders, with appropriate protections against international tax evasion. In light of the widespread international acceptance of the OECD model, any other choice would, in many cases, make the achievement of treaties impossible. These considerations have prevailed in the design of the U.S. model, despite the fact that much of the language used in that model is not found in the Internal Revenue Code; that some of the concepts of the OECD model are relatively unfamiliar as well; and that, in certain respects, we believe that substantive rules in the OECD model stand in need of improvement.

Those departures we have made from the OECD model are not generally motivated by differences in economic theory or differences in our view of the practical requirements of international tax cooperation. The only major exceptions to this statement are the reciprocal interest exemption and the investment and holding company provision. The interest exemption does reflect a consistent U.S. preference for a stricter "residence" basis approach to taxing liquid international capital which moves freely from country to country; but the approach we pursue is at least implicitly conceded by the commentary to the OECD model. The investment and holding company provisions are, we believe, essential attributes of a modern bilateral treaty; but here again, the commentary acknowledges the validity of our position, and we are currently pursuing discussions at the OECD aimed at devising a common international view of the treaty abuse. In general, if we believe a deviation from the OECD model is warranted based not on some peculiar circumstance of our position but because of deficiencies in the OECD approach, it is advisable to raise the question at the OECD, in an attempt to secure modification of the international model.

In general, most of the deviations we have made from the OECD model are an outgrowth of peculiar features of U.S. law. It is not necessarily true that our statutory practices in these regards are optimal, but treaties are intended to function against a backdrop of domestic law.

Finally, we are prepared to deviate from the OECD model in some instances in anticipation of changes in U.S. statutory law. Ordinarily, we would not deem it wise to change treaty policy in anticipation of statutory changes, because the changes might never occur. But we are conscious of the fact that treaties remain in effect for substantial periods of time, and are not subject to easy revision once they enter into force. Thus, when we perceive a likelihood that legislation will be enacted, and a difficulty with existing treaty policy if it is enacted, and when we view the potential legislation and the treaty policy changes as essentially sound, we are probably wisest to anticipate the legislation and modify our negotiating policy as appropriate.

Selecting treaty partners.—In cases where another country requests treaty negotiations with the United States, we are usually disposed—subject to scheduling constraints—to comply. Normally, we try to establish at the outset some of the groundrules under which we want negotiations to take place. For example, we forward a copy of the U.S. model in advance, sometimes accompanied by an explanation of its particular features; and we endeavor to make clear the United States position in regard to tax sparing and other incentives for foreign investment. Generally we indicate, in regard to treaties in existence, that we prefer not to negotiate exclusively for the purpose of changing a single provision. Existing treaties almost invariably stand in need of general updating, and if we are to meet we generally prefer a full review.

Insofar as United States initiated negotiations are concerned, it is best to distinguish between countries with which we already have a treaty and countries with which we seek a treaty for the first time. With respect to the former category, the most important instance where we might request negotiations would be where the treaty arrangement is producing unintended consequences. A leading example would be those treaties which give rise to extensive treaty shopping. Another case for U.S. initiated negotiations would be where significant changes in a treaty partner's law have undermined the functioning of the treaty or have altered the bargain represented by the treaty. An example would be our treaty arrangement with Italy, which has completely altered the tax system covered by the treaty in force.

A third case would be where a change in our own law has affected the operation of the treaty. Of necessity, we are slower in initiating renegotiation of treaties in this case, since changes in our law typically leave us with a host of treaties requiring revision. For example, the United States has not concertedly sought renegotiation of treaties to reflect changes brought about by the Foreign Investors Tax Act of 1966; over time, however, we have entered into negotiations because of other circumstances to revise at least half of those treaties; in these negotiations we have undertaken the necessary process of moderation. A systematic program to revise outdated treaties is on our agenda, but it does raise serious problems with the allocation of our staff resources.

A fourth case of U.S. initiated negotiations would be where Congress by statute overrode provisions of our treaties. This has occurred only rarely; the best known example was a provision of the Revenue Act of 1962 which overrode our estate tax treaty with Greece, which was then renegotiated. Congress is, however, now seriously considering adopting legislation to tax foreign investors on their capital gains from sales of United States real estate, and the pending legislation by its terms would override inconsistent treaty provisions after a 5-year delay. Our hope is that, in that 5-year period, we could negotiate protocols with the various countries with which we have treaties that would be subject to the override.

With respect to countries with which we have no treaties, we make it clear that we stand ready to negotiate but ordinarily do not urge any particular country to commence negotiations. We generally make the point that a tax treaty has substantial value, because it establishes fiscal relations between the two countries and because it represents an indication to private investors of the existence of a stable climate for investment. We normally do not press particular countries to negotiate, because it has been our experience that negotiations have the best chance for success where the other country comes on its own to recognize the desirability of a treaty relationship.

The treaty bargaining process.—In the process of bilateral bargaining, there are issues on which the U.S. and OECD models differ, where we are asked to make concessions in the direction of the OECD model; there are issues where we are asked to agree to a provision contrary to both models; and there are novel questions on which the models are silent.

With respect to movements in the direction of the OECD model, and movements away from both the U.S. and OCED models, there are some issues we never concede, and some where we must make a judgment based upon the overall balance of the treaty bargain. We do not concede, for example, on citizenship basis taxation; protecting provisions of U.S. law intended as penalties; noncoverage generally of state and local taxes; protection against at least some forms of discrimination; and the U.S. statutory rule regarding corporate residence. These are issues where we perceive a strong national interest reflected in the U.S. model. While we might make a concession on at least some of these issues in certain circumstances without serious impairment of our interests, we prefer not to establish precedents clearly contrary to the model on these questions. We believe each treaty represents a separate bargain, and do not grant make concessions simply because they have been granted in other negotiations. Nevertheless, in practice it is sometimes difficult to convince another country that we have good reason for not accepting a provision that we have accepted elsewhere.

On the other hand, there are provisions in the U.S. model which are different from those of the OECD model but to which we do not ascribe great significance. For example, the rules for resolving cases of dual residence of individuals are different in our model from those proposed by the OECD. We believe our rules are better than those of the OECD, but the differences are of little practical importance and we have been prepared to adopt the OECD rules.

Between these extremes lie a wide range of issues which must be considered on a treaty-by-treaty basis. The factors we normally take into account in making the necessary judgments are the practical importance of a concession to the United States and U.S. taxpayers; the provisions of foreign law that will be operative if the concession is made; the degree to which a particular concession might be regarded as a precedent for other negotiations; and the difficulties that a particular concession might create for the ratification process.

With respect to issues not covered by existing models, our objective in seeking agreement is frequently not conformity to principle but the establishment of a principle itself. Issues regarding the imputation credit are of particular difficulty precisely because what is involved for both countries is the establishment of a new principle. Eventually, of course, whatever principle is embodied in the treaties will, in some form, find its way into the work of international organizations, since that work has always been not so much a process of formulating abstract rules as of elaborating rules established, more or less, by usage. Because of the size and economic importance of the United States, we have special responsibilities in this regard; often when a new and serious international problem arises, like that created by the imputation systems, other countries will await the outcome of our negotiations before pursuing their own. These considerations can make bilateral negotiations over new issues very difficult.

Particular negotiations may raise special issues not covered, or not covered in sufficient detail, by the models. For example, discussions of information exchange with bank secrecy countries, and discussions of treaty shopping with tax havens, have made these negotiations unique. In these discussions we are not aiming at establishing or clarifying fiscal relations between two countries, but at solving a serious problems for the tax system. Just as we have fundamental concerns involved, the other country has concerns which it views as equally fundamental. In the best of circumstances the "trade" made in such negotiations involves a compromise which improves the situation for both sides, without requiring ultimate concessions by either.

Implementing tax treaties: the "competent authority" function.—Under all tax treaties, certain powers and duties are delegated to the "competent authorities" of the contracting states. Under the U.S. model, and under our treaties in force, the term "competent authority" is the Secretary of the Treasury or his delegate; in practice, the Secretary has delegated this responsibility to the Commissioner of Internal Revenue, who in turn has delegated day-to-day responsibilities to the Assistant Commissioner (Compliance) of the Internal Revenue Service. On matters involving legal interpretations of treaties, the Assistant Commissioner (Compliance) is enjoined to seek the concurrence of the Assistant Commissioner (Technical).

The treaties spell out a number of assignments of the competent authority. The typical "mutual agreement" article states that a taxpayer may appeal to the competent authority of the state of which he is a resident or national, if he believes he is being subjected to taxation not in accordance with the treaty. The treaties authorize the competent authorities to agree to a definition of a term not defined in the treaty if an agreement on a common meaning is necessary or desirable. In addition, the treaties make the competent authorities responsible for conducting the information exchange permitted or required under the treaties. The competent authorities are authorized to communicate directly for the purpose of discharging their responsibilities. This provision is necessary to obviate the need for using diplomatic channels to effect communication between the two contracting states.

One issue with respect to the implementation of our treaties grows out of the manner in which responsibilities for conducting the treaty program and implementing treaties are divided within the Treasury Department. The Internal Revenue Service is not, in general, responsible for the conduct of treaty negotiations; that function is reserved to the Treasury's Office of Tax Policy. Of necessity, however, the Service is assigned the task of handling the "competent authority" process. The most important reason for this is that the Service is in possession of the information which another country would be likely to request pursuant to a treaty, and knows what information the United States might need. In addition, the Service has the prime responsibility for handling individual tax cases.

Public and congressional participation in the treaty negotiating process.—One final problem touching on the management of the treaty program concerns the difficulty of engaging Congress and the public in the process of formulating treaty law. Treaty negotiations are conducted on a government-to-government basis, and the provisions of a treaty are not revealed publicly until after a treaty is signed. This means that outside interested parties do not have a full opportunity to comment upon, or to participate in, the development of the provisions that will be included in the treaty; the treaty is presented as a fully negotiated document when it is transmitted by the President to the Senate for advice and consent.

We have taken several steps in recent years to mitigate this problem. In 1976 we published the U.S. model, calling for public comments. The model represents our initial negotiating position; through its publication we intended to apprise the public of our objectives in treaty negotiations, and we have, in fact, received significant comments on the model. Second, we have undertaken in recent years to announce publicly at least the outset of treaty negotiations; and as of 1978, for negotiations showing promise of leading to treaties, we have held public meetings to discuss the major issues and the negotiating positions of the United States. In order to do this we must obtain the consent of our negotiating partner; and often we are constrained, at the request of other countries, in what we may publicly discuss. Most other countries with which we have negotiated treat the negotiating process as strictly secret. For this reason we have generally declined, in our public meetings, to divulge details regarding positions taken by the other country. Nevertheless, we do manage, through these meetings, to alert the public to most of the major issues in the negoiations, and we have frequently received useful comments and suggestions as a direct result.

Finally, the ratification process ensures full public participation after the signature of a treaty, but before it enters into force. If a provision is found objectionable to the Senate, there is ordinarily opportunity to reopen the negotiations to change the provision, although this process may involve making collateral concessions to the treaty partner.

In general, it is difficult to see a way to avoid restrictions on public participation in the treaty negotiating process. Other countries typically insist upon some degree of confidentiality for the negotiations. Moreover, fully discussing our negotiating positions, the importance each has to us, our reasons for them, and the like would tend to undermine our own position in the negotiating process. This would have the effect of prolonging negotiations generally, and would inevitably result in less favorable bargains for the United States than we might otherwise be able to obtain.

III. CONCLUSION

In summary, the United States tax treaty policy is founded upon established international principles and practices, accommodated to reflect the special characteristics of our tax system. The essential long-range objectives of the tax treaty program are to eliminate the impediments that double taxation, or the threat of double taxation, might pose to the international flow of goods, capital, and persons, and to establish fiscal relations between the United States and other nations. In pursuing these objectives, we are sometimes forced to agree to compromise provisions that are not ideal, and to accept rules governing transactions with one country which may be different from those governing similar transactions with another. But if one considers the difficulties of making accommodations with the multitude of varying tax systems in the world today, the value of tax treaties to international economic activity clearly makes them worth these relatively small costs.

For the moment, the major short-term objectives of United States treaty policy are three-fold: First, we must update and modernize our treaties presently in force. This process will eventually eliminate some of the irregularities of the extant pattern of treaty law. Second, we must revise those few treaties which give rise to abuse, for the sake of the integrity of the tax system and to ensure that the treaty program does not result in an unjustified loss of revenue to the United States. Finally, we need to work to expand our treaty network, particularly with developing countries. These objectives are serious and important, and they deserve a high priority; we are devoting to them as much time and effort as we can.

Mr. GIBBONS. I assure you we will have some questions for you after we hear the other witnesses.

Our next witness is Prof. Hugh Ault, Boston College School of Law.

STATEMENT OF PROF. HUGH J. AULT, BOSTON COLLEGE LAW SCHOOL

Mr. AULT. Thank you, Mr. Chairman.

I am pleased to be here today to testify at your hearings on tax treaty policy. I think it is an important question and one that deserve a full airing. I would like to discuss first the general goals of our treaty policy, particularly in connection with treaties with developed countries and then to focus on some specific problems that have arisen in the context of developed country negotiations. I will then talk about the somewhat different problems involving treaties with developing countries.

I may cover a little of the same grounds that Mr. Rosenbloom covered, but I think these matters are complicated enough that perhaps a second look wouldn't hurt.

Mr. GIBBONS. I agree with you.

Mr. AULT. To try to define the goals of our tax treaty policy with respect to U.S. taxpayers and the U.S. Government, I would say basically there were three goals. One is the avoidance of double taxation, the second is the avoidance of excess taxation, and the third is assuring the United States of a fair share of the revenues that are generated by international activities.

Now with respect to the first goal, the avoidance of double taxation: In fact, treaties play a relatively insignificant role. This is because of the unilateral grant by the United States of the foreign tax credit for foreign income taxes paid on foreign income. That is an important perspective to keep in mind in any discussion of treaties and their effect on U.S. taxpayers. The United States has already unilaterally, through the foreign tax credit, resolved the vast majority of the problems involving double taxation.

However, a second problem that the foreign tax credit can't resolve is the problem of excess taxation. This occurs when the foreign rate of tax is in excess of the U.S. rate of tax that would be imposed on the U.S. investor. The basic tax policy goal of U.S. international tax policy is that the United States should be neutral with respect to domestic investment versus foreign investment by its taxpayers. It is thus an important treaty goal to reduce foreign taxation where that taxation is in excess of the U.S. rate and would not be entitled to credit under domestic foreign tax credit mechanism.

That involves a reduction, in the negotiating process, of source country tax. In other words, take the case of the U.S. company investing in a treaty partner. In the treaty negotiations, the treaty partner would agree to reduce its tax at least to the level that the tax would be the same as the level of U.S. tax on the corresponding U.S. investment by that U.S. taxpayer.

The third aspect of treaty policy, even when the foreign tax is not any higher than the U.S. tax, is to assure that the United States obtains an adequate share of revenue from that income because by unilaterally granting foreign tax credit, we have unilaterally said that the source country is entitled to that income up to the level of the U.S. tax. By getting the source country to agree to reduce the level of taxation, the U.S. Treasury has gained revenues that it otherwise lost through the unilateral granting of the foreign tax credit.

That is the system from the point of view of the United States and the U.S. taxpayer. From the point of view of the foreign taxpayer, the United States, in its role as the country of source, reduces its source jurisdiction in the same way that the foreign treaty partner reciprocally reduced its jurisdiction.

Second, and quite important, the tax treaties also insure that the foreign country agrees to give some sort of double taxation relief to its citizens investing in the United States. In other words, it undertakes in the treaty to eliminate double taxation on U.S. income for its taxpayers, which is obviously important from the U.S. perspective to insure that the investment decisions made by the foreign investor are neutral with respect to the United States and the foreign country.

Finally, the treaties contain important provisions with respect to the exchange of information and the general coordination of the tax systems of the two countries. Those in broad outline are the goals of the U.S. treaty policies with developed countries.

There are a number of special problems which have arisen in negotiations currently, and I would like to briefly mention those so you can get a feel of the range of problems that our negotiators are faced with.

A particular problem arises out of the so-called integration system of corporate and individual tax, which is currently used in a number of European countries. Those systems, as domestically structured, do not grant a credit for the corporate tax paid to foreign shareholders, although they do grant that credit to domestic shareholders.

The United States has viewed that situation as discrimination against U.S. shareholders in foreign corporations and has attempted in its treaty negotiations to obtain a reduction of withholding taxes, or the direct grant of that credit for U.S. taxpayers.

We had some success in negotiations with the United Kingdom. The negotiations with Germany are currently at a stalemate.

A second problem is the overlap of citizen and resident jurisdiction taxation. As Mr. Rosenbloom mentioned, the U.S. taxes its citizens on their worldwide income, but a number of countries also tax on the basis of residence, so the same taxpayer can be subject to worldwide taxation by the United States and by his country of residence.

The recent treaty with France has attempted to work out a solution to that question by, in effect, giving the country of residence precedence over the country of citizenship. I think that raises a basic policy question because unlike the treaty model that I indicated initially, that has the effect of changing the U.S. tax burden on U.S. taxpayers, something which has not traditionally been done in treaties.

Several technical problems remain difficult in the context of treaties with developed countries.

First, there is a problem of the classification of taxpayers as partnerships or corporations where one jurisdiction says a particular entity is a partnership, another jurisdiction says it is a corporation.

Finally, there are important and, I think, overlooked problems in branch taxation. Where a company operates not as a subsidiary but as a foreign branch, how should those branch profits be determined? The U.S. Internal Revenue Code has one set of rules. The treaties, however, seem to be going from quite a different set of assumptions, and I think considerable thought needs to be given to the coordination in that context of Treasury rules and Code rules.

With respect to treaties with developing countries, the basic problem, really, grows out of the analysis that I just finished. Fundamentally, the function of treaties is to reduce source country taxation, but a less developed country as a source country is usually very reluctant to give up the revenues that would be involved by reducing its source jurisdiction.

Similarly, the developing countries typically don't want the United States to reduce its source country jurisdiction because they don't want the capital to flow from the developing country to the United States.

This is all against the background, which must be kept in mind, that the United States has granted unilaterally a foreign tax credit for the foreign taxes paid to the country of source.

So, it is difficult to have treaties play their traditional role; that is, the reduction of source country taxation, in the context of our relations with developing countries.

The U.N. model has attempted to resolve these questions or come to some compromise on these questions in increased recognition of source country taxation, and also by setting up with some more rigor the standards under which that source country's jurisdiction should be exercised. I think the U.N. model is a very interesting and important start, which should be helpful to the United States as it attempts to have treaties with developing countries.

Our treaties have not contained development incentives for developing countries and I think that is appropriate, and that that policy should be continued.

I think a possible useful aspect of treaty negotiations with developing countries would be to strive for perhaps a more limited treaty which does not have to resolve the problems of the extent to which source taxation is to be limited. A treaty which involved exchange of information and nondiscrimination articles might be a useful step without having to resolve the much thornier issues of source country taxation.

I would like to talk briefly, since the topic came up earlier, about problems of tax havens and treaties.

I think that there is no question that the United States should not have treaties with tax haven countries. All of the purposes that I just indicated really have no function if the country itself does not have a developed income tax system.

I think it is a historical accident that we do have treaties with tax haven countries. However, I think that a small corner of the problem. The problem of tax havens and the problem of treaty shopping should not obscure the basic role that treaties play in facilitating international commerce.

I think, on the whole, the process is moving in the right direction. I think our treaties help to insure neutrality of international taxation for U.S. investors and attempt to insure a fair share of revenues for the United States from international income.

Thank you, and I have a longer prepared statement.

Mr. GIBBONS. We will put it in the record at this point.

[The prepared statement follows:]

STATEMENT OF HUGH J. AULT, PROFESSOR OF LAW, BOSTON COLLEGE LAW SCHOOL

My name is Hugh J. Ault and I am a Professor of Law at Boston College Law School. I am pleased to appear before the Committee today in connection with your hearings on the role of tax treaties in the U.S. international tax system. In this statement, I would first like to outline briefly the underlying principles of the U.S. tax system applicable to the foreign income of United States taxpayers and to the United States activities of foreign taxpayers doing business here. It is against the background of these rules that the role of tax treaties in our system must be understood. I would then like to comment briefly on the relation among the various model treaties and on some specific treaty problems which are of current importance.

I. INTRODUCTION

The United States taxes the worldwide income of its citizens, residents, and corporations and grants a credit for foreign income taxes levied by foreign taxing jurisdictions on that income. Thus, United States as the country of residence in effect unilaterally cedes primary taxing jurisdiction to the country of the source of income. Taxes paid to the foreign country reduce on a dollar for dollar basis the U.S. taxpayer's liability to the U.S. Government. Thus, double taxation of the income subject to the taxing claims of two jurisdictions is avoided. It is important to note that the United States has unilaterally extended the foreign tax credit to eliminate problem of international double taxation on the foreign source income of United States taxpayers.

Correspondingly, on income arising in the United States which is paid to foreigners, the U.S. asserts taxing jurisdiction based on the fact that the income has its source within the United States and imposes a tax either on a net basis, that is, allowing for deductions of the costs of producing the income or, in the case of income such as dividends, royalties, interest, etc. in the form of a 30 percent withholding tax on gross income.

This assertion of source jurisdiction taxation by the United States may or may not result in international double taxation of the income in the hands of the foreign recipient, depending on whether his country of residence does or does not provide some unilateral form of relief from double taxation such as a foreign tax credit or an exemption for income arising abroad.

II. ROLE OF TAX TREATIES GENERALLY

It is against this background of the generally applicable United States international tax rules that the role of tax treaties affect four different sets of relationships which can arise out of any international activity: (1) The relationship between the United States and the United States taxpayer with foreign income; (2) The relation between the foreign country and the United States taxpayer with income arising in that country; (3) The relationship between the United States and a foreign taxpayer with income arising in the United States; and (4) the relationship between a foreign country and a foreign taxpayer with income arising in the United States. Tax treaties play a differing role in each of these four relationships.

First, with respect to the relation between the United States and the United States taxpayer with foreign income, in general tax treaties are not of great significance. This is because the United States has already unilaterally granted the United States taxpayer a foreign tax credit for foreign income taxes imposed on his foreign source income. United States taxpayer a foreign tax credit for foreign income taxes imposed on his foreign source income. United States tax treaties typically contain a so-called "savings clause" which provides that the United States may continue to tax the United States taxpayer as if the tax treaty had not come about. Unlike a number of foreign jurisdictions, U.S. tax treaties thus do not in general create any affirmative rights for U.S. taxpayers; at most, as will be discussed below, they allow a coordination of United States and foreign rules in order to better implement the foreign tax credit, which the

U.S. has already granted unilaterally, to the specifics of the tax relationship between the particular countries.

It is with respect to the relationship between the United States taxpayer and the foreign country that tax treaties have their most significant role. Under most tax treaties the country of the source of the income agrees to reduce or eliminate its tax on income arising within its jurisdiction. This reduction in source tax jurisdiction can have two effects. If the overall rate of tax on the United States taxpayer in the foreign country is above the effective rate of tax in the United States, the reduction in source country tax directly reduces the overall tax burden which the United States taxpayer will have to bear. On the other hand, if the source country rate of tax is lower than the United States rate, the United States taxpayer does not benefit directly; the amount of foreign tax credit which the United States has granted him unilaterally is simply reduced and the U.S. taxpayer pays more tax to the United States and less tax to the foreign country, but this overall effective rate of tax remains the rate imposed by the United States. However, the United States Treasury gains since it in effect recovers tax revenues which the U.S. had already unilaterally ceded to the source country through the foreign tax credit. Thus, despite the denomination of the United States tax treaties as treaties for the avoidance of double taxation, the treaties really play a relatively minor role in questions of double taxation. Their primary function is first to deal with situations of excess taxation, and secondly to allow the United States Treasury, in those situations in which the foreign tax rate is equal to or less than the United States tax rate, to recoup some of the lost revenues which the United States has initially given up through its automatic granting of a foreign tax credit.

The third set of relationships involved in a tax treaty is the relationship between the foreign taxpayer with United States income and the United States. Here, the United States, in its capacity as the country of the source of the income, is obliged to either reduce or eliminate the tax which it would generally assert. This is typically done either through a reduction or elimination of the usually applicable gross withholding tax on payments such as dividends, interest, royalties, etc., or by raising the threshold of activity required for the United States to tax business income arising in the United States. In these situations, the United States, in its capacity as country of the source of the income, is recognizing the primacy of the tax claim of the residence country of the foreign investor.

The final tax relationship involved is the relation between the foreign taxpayer and his own government. Here United States tax treaties have required that the foreign government agree to relieve double taxation on income arising in United States, thus recognizing the primacy of the United States claim to tax the income as the country of source in those situations in which its taxing jurisdiction is still retained under the treaty. This clause can be significant for, unlike the United States, a number of other countries do not unilaterally relieve double taxation and the requirement that such relief be granted can remove an important impediment to investment by such taxpayers in the United States.

Thus, viewed broadly, United States tax treaties are important from the perspective of the United States taxpayer primarily in reducing excess tax burdens; from the point of view of the foreign taxpayer they are significant in reducing the United States tax which would ordinarily be applicable, and in assuring that, when that tax is applicable, the country of residence will fulfill its responsibility for avoiding international double taxation by granting some sort of relief from the United States tax. From the perspective of the two treasuries, the tax treaty is an instrument for arriving at an acceptable basis for sharing the tax revenues which are generated by inter-country activities.

III. DIFFERENTIAL IN MODEL TREATIES

The Committee has asked for comments on the differences between the OECD and the UN Model Treaties and the U.S. Model Treaty. With respect to the OECD treaty, the U.S. Model Treaty is substantially similar. The principal differences evolve out of the fact that the United States asserts worldwide taxing jurisdiction on the basis of citizenship while most other countries limit worldwide taxation to residents of the country. Consistent with its citizenship approach, the U.S., through the savings clause, also does not in general grant affirmative relief to United States taxpayers through tax treaties. In a number of the OECD countries, however, the tax treaty serves as an instrument through which rights are created directly in the domestic taxpayer against his government. Apart from these basic differences, the goals of the OECD and the U.S. Model Treaties are by and large the same and there are only a relatively few technical differences. For example, the OECD Model treats as domestic a corporation which is effectively controlled in the taxing jurisdiction. This concept of corporate residence is not used in U.S. domestic law and correspondingly is not contained in the U.S. Model Treaty. There are also differences in the limitations on the assertion of source jurisdiction taxation. Thus the U.S. Model reduces the withholding tax on interest to zero while the OECD Model provides for a 10 percent rate. On the whole, however, the goals and techniques of the two Model Treaties are similar.

With respect to the United Nations Model Treaty, constructed to deal with relations between developing and developed countries, the differences are much more substantial. It is important to recognize clearly why this is the case. As outlined above, normal international tax rules give primacy of taxing jurisdiction to the country of source with a concomitent obligation on the country of residence to relieve international double taxation either by a foreign tax credit mechanism or by exempting foreign source income. Tax treaties, however, then reassert the right of the country of residence to tax the income by requiring the country of source to reduce or eliminate the assertion of its taxing jurisdiction. This system works well enough in relations between developed countries where investment flows are roughly equal. Where the country of source reduces its taxing jurisdiction it receives in return a similar reduction in the source jurisdiction taxation of the other country as applied to its taxpayers. Thus, problems of excessive taxation or, in certain situations, of possible double taxation can be avoided and an appropriate sharing of the flow of international revenues between the two countries can be achieved. However, in the case of developing countries, the investment flows are often all in one direction. Thus, the developing country, as the source country jurisdiction, is reluctant to reduce its source jurisdiction in a tax treaty. The UN Model Convention reflects this philosophy by having a number of provisions which recognize to a greater extent than either the U.S. Model Treaty or the OECD Model the right of the source country to continue to assert its taxing jurisdiction. Thus, for example the OECD and the U.S. Model Treaties provide that a building or construction site will only constitute a permanent establishment (thus giving the source country the right to tax) if it lasts for more than 12 or 24 months respectively. In contrast, the UN Model finds a permanent establishment if the activities last for more than six months. Similarly, the U.S. and OECD Models both eliminate entirely the source country tax on royalty payments. The UN Model, however, allows the source country to continue to tax royalty income, with the rate to be determined by bilateral negotiations.

From the U.S. point of view, the issue is whether to accept a wide taxing jurisdiction by the country of source. The U.N. Model offers a useful starting point for negotiations.

IV. RELATION OF CODE AND TREATY PROVISIONS

1. Generally

By definition treaty rules make changes in the otherwise applicable rules in the International Revenue Code. Because of the savings clause, however, these changes generally do not affect a United States taxpayer in his tax relations with the United States. There are, however, some exceptions to this principle. For example, tax treaties sometimes change rules with respect to the determination of the source of income. In the context of a tax treaty, this has the result that the country of source has the primary claim to tax such income and the United States, as the country of residence, is obliged to give a credit for the foreign taxes paid on such income. This credit would not normally be forthcoming under the Code, because, in general, foreign taxes imposed on income which the United States deems to be domestic source income are not entitled to the credit. Thus, from the point of view of the United States taxpayer, his overall tax burden can be reduced by tax treaties to the extent that the treaty has the effect of requiring the United States to grant a credit for foreign taxes paid which ordinarily would not be entitled to the credit.

It is primarily in relation to the taxation of foreign taxpayers with United States income that tax treaties change the basic substantive tax rules. This can be either through a reduction of the otherwise applicable United States withholding tax or through a complete exemption from United States taxation, for example, in the situation of business activities undertaken in the United States which do not amount to what is technically referred to as a "permanent establishment" in the United States. Since our treaty network has developed over a number of years there is a need to coordinate the Code provisions and the treaty provisions as they are applicable to foreign taxpayers. For example, under the Internal Revenue Code a taxpayer involved in rental activities in the United States may make an election to have those activities taxed on a net basis. However, that election, once made, is generally binding for all future taxable years. A number of our older treaties allow such an election to be made on a year by year basis. The U.S. Model Treaty has coordinated these rules by requiring that the election be made on a permanent basis.

In general it is important that treaty articles be coordinated with the otherwise applicable domestic rules to avoid any potential discontinuities. Several problem areas are discussed below.

2. Some specific problem areas

(a) ***Branch taxation.***—Under applicable Code rules, a foreign taxpayer who operates in the United States through a branch is taxed by first determining under the Code rules what income is treated as "effectively connected" with his branch operations and then allocating to that income a portion of the expenses incurred by the foreign tapayer. The U.S. Model Treaty and the OECD Model, however, approach branch taxation from a somewhat different perspective. There the branch is treated as a fictitious "independent" taxpayer dealing with the head office on an arm's length basis. There is substantial uncertainty under current law exactly how the Code rules and the Treaty rules interact. More thought has to be given to the extent to which branch income should be determined on a "arm's length" basis and to what extent an allocation approach is more appropriate.

(b) ***Creditable foreign taxes.***—The Internal Revenue Service has recently proposed extensive Regulations dealing with the question of when a foreign tax qualifies as an income tax and hence is available for credit and the treaties likewise indicate what foreign taxes will be creditable. The foreign tax credit article of the treaties is generally an exception to the usually applicable "savings clause" and thus United States taxpayers may claim a credit for foreign taxes covered by the Treaty even where those taxes might not be creditable under the standards of domestic U.S. law. An important policy issue is whether the United States should, in its treaties, allow a credit for taxes which would not otherwise be creditable under domestic standards. For example, in the recently concluded U.S.-United Kingdom Treaty, the Treaty expressly grants a credit for the U.K. petroleum revenue tax which the Internal Revenue Service had previously ruled was not creditable under the usually applicable tests.

(c) ***Overlap of citizenship and residence-based taxation.***—While international double taxation most usually occurs because of an overlap of taxing jurisdictions based source and on residence, such an overlap can also happen if both countries are asserting the right to tax on a worldwide basis. This can arise where a U.S. citizen is resident in a foreign country. The U.S. asserts a tax on his worldwide income because of the citizenship connection while the foreign country likewise asserts a worldwide tax based on his residence in the country. A similar problem can arise in the corporate context where two jurisdictions both consider the corporation "domestic." The recently ratified protocol to the treaty between the United States and France resolves this problem by in effect ceding primacy of taxing jurisdiction to the country of residence. This is accomplished technically by treating certain income as having its source within France which under normal United States rules would have been United States source income. Hence the French tax imposed on this income in effect becomes creditable. As in the case of the determination of what foreign taxes qualify for the credit, this treaty rule has the effect of reducing the United States tax burden on United States taxpayers. Further thought needs to be given as to whether this approach is appropriate.

V. NONDISCRIMINATION

Most United States tax treaties contain a provision which requires that the treaty partner not impose taxation on United States taxpayers which is "more burdensome" that the taxes imposed on the state's own nationals. Such articles can insure an even-handed treatment of United States taxpayers in the foreign jurisdiction. The nondiscrimination clauses, however, do not cover some situations in which United States taxpayers can be disadvantaged by the foreign tax system. The most important current issue involves the treatment of United States shareholders in corporations formed in countries which have a "integration" form of corporate taxation. Under such systems, domestic shareholders in the corporation are in effect refunded all or a portion of the tax paid by the corporation when corporate profits are disturbed. Such systems uniformly deny such a credit to foreign shareholders in the domestic corporation. In the recently concluded United States-United Kingdom Treaty, the United States was able to obtain such a credit. Present negotiations with Germany on this point, however, are at a standstill.

VI. CONCLUSION

Viewed broadly, United States tax treaty policy involves the resolution of a number of complex policy issues. In our relationships with developed countries, we must negotiate agreements which achieve for United States taxpayers a reduction of a potentially excess overall tax burden. From the perspective of the United States treasury, we must assure that the United States obtains a fair share of the international revenues generated by relations between the countries. The current difficuities in dealing with the problems created by the introduction in a number of European countries of an integration system of corporate taxation underline some of these difficulties. With respect to treaties with less developed countries, it must be recognized that a normal model of treaty relationships is inappropriate, given the desire of the developing countries to retain a substantial level of source country taxation. This is not to say that concluding treaties with less developed countries is impossible, but only to suggest that they may involve different and somewhat more limited accommodations than the United States has traditionally achieved in its tax treaty network.

Mr. Gibbons. Our next witness is Mr. Robert Patrick, senior tax counsel, Exxon Corp.

STATEMENT OF ROBERT J. PATRICK, JR., SENIOR TAX COUNSEL, EXXON CORP.

Mr. Patrick. Thank you, Mr. Chairman. I appreciate being invited here in my personal capacity in view of a number of years of interest that I have had in this area, including several years at the Treasury Department. I would like to summarize some of the principal points of my prepared statement. I would like to begin by emphasizing what I think is an important perspective concerning the role of tax treaties in the international tax system and then discussing briefly the relative significance of treaties in the U.S. tax system.

I think the most important thing that can be said on behalf of tax treaties is that they fill a major gap that is otherwise void in international efforts to create institutions for harmonization of income tax rules affecting trade and investment.

There was some allusion earlier to the diffculty of obtaining international collaboration in the tax area. In other important areas, such as in the trade area with GATT, under the multilateral trade agreements, and in the monetary area, where you have an institution like the International Monetary Fund, you have regular consultation at high levels of government and international rulemaking bodies.

There have been some successes through these institutions in furthering of communications and cooperation in formulating international economic policy. It is striking to me that the tax area, which obviously has its own bearing on investment flows, on exports, and on the behavior of companies and individuals, is simply an area in which there has been very little multilateral agreement, and there certainly is no international institution or rulemaking body.

Instead, what has occurred to date has been the development, on a bilateral basis, of tax treaties, running into hundreds of income tax treaties. This has several effects. One is that the bilateral treaties do create a degree of harmonization of tax treatment of business and tax administration around the world. This development has been furthered by the development of model income tax treaties, basically adapted from the practice in existing treaties, as we have seen in the League of Nations, and as David Rosenbloom described, in the OECD, in which the United States participated in preparing the 1977 model, and finally in what I think is a remarkable development, the recent agreement of the group of experts in the United Nations on Guidelines for Treaties Between Developed and Developing Countries. The latter comes at a time in which everyone is well aware of the north/south dialog, and the problems of experts of any kind getting together and agreeing on international rules. I believe that the provisions of these model treaties are really very close to, and in general, quite acceptable to, U.S. tax treaty policy as I understand it, and as it is being developed. The U.N. guidelines present, moreover, a very real possibility for bringing a great many developing countries into the international tax system which, in my opinion, has advantages for the conduct of business, for economic development, and for tax administration.

It is indeed a phenomenon that the developed countries of the world have pursued broad treaty networks. The British, for example, who are similar to us in having a foreign tax credit system for unilateral relief of double taxation, have some 79 tax treaties in place, and 6 or so under negotiation. I believe that this emphasis on very extensive treaty networks, which is also found in other countries, is linked to their view of the importance of international trade and development and their willingness, therefore, to share the tax allocations and to give investors and traders a greater climate of certainty in operating rules.

I would emphasize that there is also the very important aspect of the treaties in permitting cooperation among the tax administrations. This is important in two respects: One aspect that has not been emphasized this morning is that there are a great many administrative problems in the resolution of double taxation. Since that is a major objective of the treaties, procedures are established and authorization is given under the treaties for the tax authorities to work together to try to resolve the appropriate jurisdiction for taxation and to provide the appropriate relief to be given on the other side.

The second aspect, which was mentioned today, is that of exchange of information. In my opinion, based on experience I have had in discussions involving exchange of information agreements and also in observing the Internal Revenue Service in its operations, these are the most effective tools today for proper tax administration and for going after tax evasion.

It is the one tool—and is sanctioned by the Congress through the provisions dealing with the Privacy Act—the one tool that is available to the U.S. tax administration to deal with a reputable foreign tax administration under an approved agreement to exchange tax information. I think it is effective and I think it is extremely important. It is also an aspect of treaty practice that I believe can be extended even to some of the countries that don't have full taxation systems.

The basic role played by the treaties is in the alleviation of the problem of who will tax and who will give double taxation relief; and it is certainly a legitimate question as to why the bilateral arrangement is necessary on top of the unilateral provisions that we have in our Internal Revenue Code.

I think there are enough examples in the details of the execution of our law that illustrate the need for a treaty response as a flexible mechanism by which different tax systems can be reconciled. Moreover, the treaty permits a reciprocal arrangement between the two countries that can be better adapted to particular circumstances and also can be refined to apply to those persons who are intended to benefit or otherwise have the treaty apply to them. That, of course, raises the issue of treaty shopping, and it is a difficult challenge to write workable rules; but a bilateral agreement permits one to at least know with whom you are negotiating and what their system is and how you want to structure an agreement with them. This is a continuing challenge to the negotiators and requires the continued review of arrangements one has entered into.

In examining the questions that were posed in the invitation to appear here, I think there are four categories of questions as to U.S. treaty policy:

First, there are treaty rules affecting U.S. taxation of foreigners, as has previously been spelled out. It is in that area where we probably see the greatest impact of treaties in changing U.S. statutory rules. We modify withholding taxes. We modify threshold rules for the incidence of taxation of foreigners operating in the United States. It is also in this area where I think one has seen historically the most significant legislative interaction between treaty rules and statutory rules, because in 1966, in the Foreign Investors Tax Act, there was a substantial effort to try to conform some of our statutory Internal Revenue Code rules on the taxation of foreigners, to international concepts, many of which were drawn from treaty practice.

As has been mentioned earlier by David Brockway, there is not a total matching of some of the concepts. It is a continuing subject for further review and consideration of the interaction between the treaty and the Code rules, and whether they can be harmonized even more closely.

A second category of treaty rules are those affecting U.S. citizens and residents. My experience is that the United States is unique in inserting the saving clause that David Brockway described into our treaties. It simply says that, basically, the U.S. domestic tax rules as they apply to U.S. citizens and residents are not affected by the treaty, the principal area of exception being the one of assuring the proper operation of the foreign tax credit rules to avoid double taxation.

There have occasionally been some other modifications of U.S. tax law affecting U.S. citizens and residents, such as charitable contribution provisions, that have been addressed from time to time in treaties; but basically the United States does not fundamentally change by treaty its tax rules as they apply to U.S. citizens and residents.

The saving clause policy is not a treaty policy of other countries. It is a very difficult thing to explain to a developing country, for example to the Israelis, as to why retired U.S. citizens maintaining U.S. citizenship, but residing in Israel, should not be exempt from worldwide U.S. tax as long as they are Israeli residents. Other countries would change their domestic law by treaty. It is a difficult negotiating issue in that context, but I think there is a fundamental general premise that for the most part the U.S. rules will continue to be applied to U.S. citizens, residents, and corporations under our treaties, and we have nevertheless seen the United States able to enter into a substantial number of treaties even with that limitation.

With respect to a third category of issues arising from U.S. objectives with respect to what foreign governments should do, I concur with Professor Ault. There is a taxpayer interest as well as a government interest in reducing maximum tax burdens, usually through reduction of foreign withholding taxes, and this may result in an inflow of some net U.S. taxation. I suspect most of our residual net revenues in taxation by the United States of foreign income comes from the very fact there are lower treaty rates, in many cases, on items such as interest or royalties brought about through the treaties. Most of our direct investment through branches and repatriated dividends probably carries full foreign tax credits.

It is also a principal objective, one that has not been mentioned here, of the U.S. treaties to include provisions for nondiscrimination with respect to both foreigners investing here and Americans investing abroad. That provides a very important substantive rule. It can be relatively easy for many countries to change their tax rules discriminatorily for a class of foreign investors. They are not likely to be voters; they may not have local political support. It has been recognized by the OECD and others that moving toward broad nondiscrimination provisions is a civilizing rule of comity and the use of treaties for this purpose is consistent with other efforts for expanded trade and investment.

With respect to treaty issues with developed and developing countries, I concur with Professor Ault's statement as to the major issue with developed countries—and it is an important one as to future U.S. economic relations—as to how the foreign governments that have integrated their taxation of corporations and domestic shareholders are going to treat the foreign investor who is outside that country.

The Common Market Commission has sought to try to get some extension of these integration rules to all residents within the Common Market countries. It has been the U.S. position that treaty partners ought to be participants in these systems to avoid distortions in investment that will otherwise occur, but it remains a tremendous challenge as to how to negotiate appropriate solutions.

The issues with developing countries, I think, are, again, as Professor Ault outlined, basically questions of their desire to tax more income at source. The United States can try to see what it might accommodate to in some of its source rules. For example, we say that income from services has its source where the services are performed. The foreign country may say that the source of that income is where the payer for the services resides. It is not clear who is necessarily right in any fundamental sense, and there must be a degree of negotiation here as to who will be the taxing country and which country will bear the tax relief.

In the case of U.S. relations with developing countries, the primary issue, and the reason we do not have very many treaties, is that for some 20 or 30 years all of the major developed countries of the world have given major tax incentives for investment in developing countries through their treaties as an instrument of national economic policy.

Canada, Germany, France, Japan, the Netherlands, the United Kingdom, Scandanavian countries provide that they will either give phantom credits for taxes that were not actually paid by their direct investors or portfolio investors in developing countries, or they will exempt income that presumably has been exempted in the host country. That makes it very difficult for the United States to go out to developing countries and say, we do not offer such incentives but we still want treaty concessions on their side.

Both the Eisenhower and the Kennedy administrations offered tax incentives to encourage investment in developing countries. The Eisenhower administration sent up so-called "tax-sparing" treaties and the Kennedy administration proposed treaties would extend the investment credit to developing countries. Both of those approaches were rejected at the time by the Senate and they have not been offered or negotiated by the United States since the 1960's.

In spite of the absence of major tax incentives in U.S. treaty policy, my own judgment is—and I think Treasury is pursuing this policy—these are not today a basic impediment to treaty negotiations with developing countries; there are fundamental grounds for the treaties without these incentives, and the Treasury can secure them. The subject of whether incentives are desirable as a matter of U.S. policy seems to me to be a policy decision for the taxwriting committees of this country; and if the United States were to have such a policy and wanted to stimulate investment through the tax system, it would be appropriate for the taxwriting committees to write the guidelines and outline how the negotiators should negotiate the incentives.

At this time we don't have them, and I don't think they are critical to our treaty program; although it has been a slow program without them.

Because there has been so much discussion about the tax havens, I would like to comment briefly. I think it is a very difficult area and poses difficult questions.

So much has been done to date on trying to develop the framework of the treaty to produce a U.S. model that I think Treasury is just reaching the stage where it can go back and look at this policy to see where the abuses are.

My understanding is they are renegotiating treaties that I think fall in dubious categories. They are also looking at antiabuse rules that can be put into the treaties.

Reference was made to the Luxembourg treaty tax haven rule. I believe the United States was the first country that ever put a rule in that said the treaty does not apply to Luxembourg holding companies. That sort of rule can be employed on a case-by-case basis as required. It requires negotiators to know what the foreign tax system is that they are dealing with, and to see how far they want to go, if at all, in making any change in U.S. withholding taxes or other taxes, depending on how they perceive the other country taxes the income.

I think, moreover, that there is no reason not to pursue—even with the sort of offshore island conduits that have been mentioned—income tax exchange of information treaties, and believe that there are some ways that these can be secured.

There was a piece of legislation approved by the Ways and Means Committee in 1975, and it did deal with the subject matter of Mr. Gradison's questions earlier about the removal of tax on U.S. interest payments to foreign investors. It had, I thought, a very important additional provision: Those withholding tax provisions could be reinstituted with respect to any country that did not agree to exchange information with the United States.

Indeed, one could carry that further and put a substantial tax on any targeted country that was refusing to exchange information with the United States where it was believed, by the Secretary of the Treasury, that there was some abuse, and particularly where American citizens were concerned and they were not cooperating.

I think those countries that position themselves as a financial entrepot or conduit for the flow of funds, if thus targeted, would have some difficulty in operating, and would perhaps evidence a willingness to cooperate.

I think, however, that it would be most effective if steps of this kind were undertaken on a cooperative basis with other developed countries, for example, the major OECD countries—it is the sort of thing that ought to appeal to their tax administrations.

Finally, in terms of the role of the treaties and their adoption, I think if they are kept in perspective, we have a system working reasonably well now. I believe that our treaties are negotiated basically to interpret the spirit of the Internal Revenue Code and the guidelines are, in effect, set down there; that the Joint Committee staff participates in the process; and that there is always the potential for revision of the rules through the taxwriting committees. Therefore, unless there were to be some major new policy to be implemented through the treaties, I do not believe it is necessary to establish an elaborate procedure for the review of the treaties along the lines other than as is presently being done.

I think the idea of consultation and communication about treaty policy and examination of the role of treaties is properly a function and responsibility of this subcommittee and the tax writing committees. When at Treasury we published the so-called United States treaty model in 1975, the objective was to let the world know what the Treasury Department was doing and what U.S. policy was. This hearing is exactly in the spirit of that objective. Thank you.

Mr. Gibbons. Thank you. We will put your entire statement in the record, Mr. Patrick.

[The prepared statement follows:]

STATEMENT OF ROBERT J. PATRICK, JR., SENIOR TAX COUNSEL, TAX DEPARTMENT, EXXON CORP.

My name is Robert J. Patrick, Jr., Senior Tax Counsel with Exxon Corporation and Chairman of the Treaty Committee of the United States Branch of the International Fiscal Association. I appear here today in my personal capacity. In view of my longstanding interest in the subject of tax treaties, I appreciate your invitation to participate in this discussion.

I believe that income tax treaties (and also estate tax treaties) are an important and useful element in the tax system of the United States. I believe, however, that their significance should not be overstated and that perspective should be maintained as to what tax treaties can and should do as a matter of tax policy.

The most important thing to be said on behalf of tax treaties is that they fill a major gap, otherwise left void, in the efforts of nations to create institutions for the harmonization of rules under which international trade and investment are conducted. In other important areas, governments have been able to create multilateral institutions for consultation and for coordination of policy and in some cases for the adoption of uniform rules. This is most clearly evidenced in trade matters under the rules and procedures of the GATT and in monetary policy through such institutions as the IMF. Income taxes, which also have a significant role in trade and investment have no similarly constituted body for consultation, let alone rule making. This gap is to some extent closed today by the widespread use of bilateral income tax treaties.

The international tax relations of the major countries of the world are conducted to an important degree under the existence of tax treaty networks. There are literally hundreds of tax conventions. Most of the developed countries have wider treaty networks than the U.S. and some like Canada and Japan have recently undertaken the aggressive pursuit of new treaties. Canada, which in 1972 had 16 treaties in force, substantially revised its tax laws in that year to place an even greater stress on the role of tax treaties compared to unilateral legislation. Today, Canada has more than thirty-two treaties now in force or signed and awaiting ratification and has numerous negotiations in progress. The Canadian government in its 1969 White Paper on Tax Reform had said:

"It seems clear that in order to continue to attract the foreign capital essential for its development and to open up further opportunities for Canadian exporters, Canada must seek to overcome tax obstacles placed in the way of further trade and international investment by other countries. To do this Canada must improve its network of tax treaties with other countries. The government will attach a high priority to this task." Minister of Finance: Proposals for Tax Reform, para. 6.6 (1969).

France has some 53 income tax treaties in force. Germany has more than 40 in force, nine more signed and 15 under negotiation; Japan has more than 34 in effect and a significant number under negotiation; and the United Kingdom has 79 treaties in force and 6 under negotiation. Why does a country like Britain, which was a contributor to the development of unilateral relief from double taxation through the foreign tax credit, attach such obvious importance to securing tar treaties? Its emphasis on tax treaties, as in the other countries, is clearly linked to a view of the importance to it of international trade and investment which entails a willingness to share tax burdens and a desire to give investors and traders a greater climate of certainty and harmonization of operating rules. There is also an increasing tendency in some countries to use treaties to provide incentives for investment in foreign countries linked to expanding markets for products and access to natural resources.

The multitude of income tax treaties in force in the world today has two major consequences. First, the increasing use of "Model" income tax treaties provides an important degree of harmonization of international tax rules among nations having widely varying income tax structures. Second, they provide an officially approved method of cooperation and exchange of information among the tax authorities, permitting more effective tax administration. I believe they are the most important tool available to tax administrations to prevent international tax evasion.

Model income tax treaties were first developed by a Committee of experts of the League of Nations. The first major post World War II treaty developments was the 1963 publication of the OECD Model Tax Convention and Commentary that was revised on the basis of experience with the first version, and reissued

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in 1977. The Canadian Government in 1969 made the following observation concerning the OECD Model and Canada's intention to expand its treaty program:

"It is not, of course, possible to forecast the exact form that Canada's tax treaties would take. They would undoubtedly vary from one country to another, depending on the results of separate negotiations. Nevertheless, over recent years a fairly standard international tax treaty pattern has emerged. This pattern has to a considerable extent been codified in a draft model tax convention published in 1963 by the Fiscal Committee of the Organization for Economic Co-Operation and Development. While few countries are prepared to accept all provisions of this draft treaty, it does generally represent the norm among the major developed countries. Canada's tax treaties will undoubtedly be influenced to a considerable extent by this draft treaty, but we too will require some modifications." Proposals for Tax Reform, para. 6.51 (1969).

I believe that the U.S. approach to the OECD Model could be described in a similar manner.

A second major event in treaty models is the completion last December of a Manual for the Negotiation of Treaties between Developed and Developing Countries prepared by a group of experts under the United Nations sponsorship. I understand that the Economic and Social Council is in the process of approving an accompanying Model Treaty based on this work. A major share of the credit for this remarkable degree of cooperation between experts from developing countries was due to the extensive participation of Professor Stanley Surrey of the United States, who served as special advisor to the project. A whole new generation of countries joining in closer tax harmonization is a potential outcome of the contribution tax of the UN experts.

For many years, the U.S. negotiated from the basis of the most recent treaty it had signed. Starting in 1975 an effort was commenced to produce a U.S. Model that would inform everyone as to the basic rules that the U.S. desired in its treaties and to permit wider comment and evaluation of U.S. policy; the type of inquiry that is exemplified by the holding of this hearing.

From the U.S. standpoint, I believe the OECD and U.N. Model Conventions are compatible with the basic domestic tax laws of the United States and U.S. international tax policy incorporated in our laws The U.S. does employ some unique approaches in its treaty policy, based upon adherence to the Internal Revenue Code, which is the touchstone for the treaties, and model treaty rules incorporated in U.S. treaties have been modified accordingly.

Apart from the broad philosophical reasons for having income tax treaties, what are the practical factors that require tax treaties as a supplement to unilateral domestic law provisions?

The basic factor in considering the role of tax treaties is the underlying effort of the treaty to allocate between two sovereigns the right of taxation of various items of income on the one hand and the responsibility for providing relief from double taxation on the other. The basic question is who will collect the tax and who will give relief? As in the case of the Internal Revenue Code, treaties operate through the mechanics of source rules, inter-company pricing rules, tax credits, exemptions and the like.

Most countries, including the U.S. and all of the developed countries, have unilateral domestic law rules that attempt to address the question of taxation rights and relief from double taxation (either by exempting foreign income or providing a foreign tax credit). These rules go a considerable way toward permitting a freer flow of trade and investment. But unilateral rules simply cannot take into account all of the detailed variations in national tax laws. Indeed, the variations are sufficiently great that bilateral and not multilateral treaties are employed to resolve the issues even in such close economic units as the member states of the European Economic Community.

One of the most recent descriptions of the supplemental role that tax treaties fill is in the recently published U.N. Manual for the "Negotiation of Bilateral Tax Treaties between Developed and Developing Countries".

"Theoretically the unilateral approach to the elimination of double taxation should involve no difficulty at the international level, since the decision to apply it depends on one State only. Nevertheless, it involves unilateral sacrifices by the State. Moreover, experience has shown that the unilateral approach to the provision of relief may not be itself fully adequate to eliminate or alleviate the effects of double taxation. This inadequacy stems from the diversity of tax systems which, in turn, originates from differences in legal and tax history, fiscal policy, revenue needs and the level of compliance and enforcement. These differences are reflected in the approach that a country takes to the promotion of foreign investment, the characterization and computation of taxable income and the various methods of allocating income to domestic and foreign sources. Statutory tax rates are not meaningful as such and are comparable only if the base to which they are applied, that is the determination of income subject to the tax, is taken into account. As a result of the growing complexity of tax systems and the multiplicity of taxes levied, it has become increasingly difficult to provide fully effective relief from international double taxation through the unilateral approach, which in practices does not always work perfectly." "Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries", U.N. Department of Economic and Social Affairs (1979).

An example of the need for bilateral solutions is offered by the 1978 Protocol with France, which attempts to deal with a difficult problem for U.S. citizens residing in a foreign country. The U.S. (and to some degree the Philippines) appear to be among the only countries in the world that impose world-wide tax jurisdiction on the basis of citizenship as well as residence. The otherwise universal standard in the world is to tax on the basis of residence. A serious double taxation problem arises where a U.S. citizen residing in a foreign country receives interest on his bank account in the U.S. or other income from U.S. investments. The U.S. taxes his investment income because he is a citizen. The country of residence taxes the same income because the taxpayer is a resident. (The U.S. does the same thing with resident aliens.)

While the U.S. has a statutory foreign tax credit, it does not help the U.S. citizen in the above case because the credit is given only for foreign tax on income from foreign sources as defined in the Internal Revenue Code and the investment income in this example is, under U.S. law, income from U.S. sources. The French or Canadians or whoever is involved are not prepared unilaterally to treat one of their residents differently from another (citizenship having no significance under their tax laws). The French Protocol thus works out a system of sharing of revenues between the U.S. (citizenship country) and France (residence country). This seems to me to be an entirely appropriate and valuable contribution of the treaty. Similar bilaterial accommodation is available for dealing with the characterization of entities (partnerships can be a confusing subject under many domestic law rules), conflicting sources of income rules, and the like.

The UN report, the Committee on Fiscal Affairs of the OECD, and the U.S. in its adoption of tax treaties, recognize that bilateral tax treaties can be used to reconcile different internal law concepts as to the nature of income produced from different activities, the geographical source of such income, the characterization of the entities involved, and the method of taxation of the income as between the two countries.

A second major contribution of the treaties is the framework for cooperation in tax administration. This involves two aspects: the first is authority for the tax administrators to resolve disputes involving double taxation and the administration of their tax laws. The second, is the very important authority to exchange information (under safeguards) to prevent tax evasion.

A third feature of treaties is a reciprocal commitment to non-discriminatory taxation of the residents of the treaty partner country. A feature of the treaties that again fills a void that would otherwise jeopardize other economic agreements designed to achieve a world of free trade and capital flows.

Finally, many countries utilize income tax treaties to implement incentive programs to attract foreign investment or to promote foreign investment, particularly in developing countries. While major tax treaty incentives for investment in developing countries were proposed both by the Eisenhower and Kennedy Administrations, the U.S. has not adopted such a treaty policy.

Whether it is a matter of accommodation and fine tuning of the details of two countries tax laws or for more fundamental policy purposes, in the words of the UN Committee of Experts:

"Tax treaties thus permit a degree of mutual accommodation which is not possible under the much less flexible statutory schemes that apply to transactions with all countries in general."

POLICY ISSUES IN U.S. NEGOTIATIONS

In my view, the major policy issues concerning income tax treaties can be discussed under the following divisions:

(A) The effect of the treaties upon U.S. tax rules governing foreigners investing in and trading with the U.S.;

(B) The effect of treaties upon U.S. tax rules governing U.S. citizens, residents and corporation;

(C) The objectives of the U.S. in negotiating treaty terms with foreign countries as to their taxation of United States citizens and residents; and

(D) Whether there should be distinctions in tax treaty rules as between treaties with developed countries and those with less developed countries?

(1) *Treaty Rules Affecting U.S. Taxation of Foreigners*

The principal substantive impact of U.S. income tax treaty rules, relative to the Internal Revenue Code, are with respect to the U.S. taxation of foreigners doing business or earning investment income in the United States. The U.S. treaty provisions are similar in structure to the Model Conventions. The treaties define the threshold of activity that makes companies and individuals (whether employees or persons engaged in independent personal services, including professionals) taxable. In the case of investment income in the form of dividends and interest and for royalties from licensing, the treaties reduce the withholding tax rates on payments to non-resident aliens and foreign corporations not engaged in business in the U.S. These provisions are generally adopted on the basis of reciprocity between the two treaty partners. The reduced rates are intended to more nearly approximate a tax on net income or to permit taxation in the country that is best placed to determine net income.

The overall objective appears reasonably clear. The treaties are to facilitate trade in the export and import of goods and services and the making of capital investments. The treaties provide increased certainty as to when tax liability is imposed and preliminary or incidental activities to which it is difficult to attribute income are not made taxable. Similarly, causal or brief visits by businessmen and professionals do not subject them to taxation.

These various U.S. treaty modifications of domestic law applicable to nonresidents are within the range of general treaty practice of all of the developed countries of the world. In addition to establishing minimum rules for the threshold for taxing a business activity and reducing withholding rates on gross income (which on a reciprocal basis can present a revenue flow to the U.S. from investments in the foreign country), additional treaty provisions reflect the intent of provisions of the Internal Revenue Code on such matters as the taxation of shipping and aircraft, real property and capital gains taxation. If as appears possible, there is to be some change in the near future with respect to the taxation of capital gains by foreigners on U.S. real property, some treaty provisions may appropriately require revision though amending protocols. Since the practice of taxing capital gains of non-residents on real estate is widely accepted, I would not anticipate widespread difficulty in obtaining such protocols.

(2) *Treaty Rules Affecting U.S. Taxation of U.S. citizens, Residents and Corporations*

Unlike the tax treaty rules of any other country, the U.S. tax treaties generally do not change the U.S. statutory rules of the Internal Revenue Code applicable to U.S. citizens, residents and corporations. This policy is embodied in a unique provision of U.S. tax treaties called the "saving clause" which provides that, with limited exceptions, the U.S. will tax its citizens, residents and corporations without regard to the treaty. The exceptions apply to certain treaty rules applicable to resident aliens and to a general agreement that the U.S., in keeping with the basic purpose of the treaty to prevent double taxation, will retain the principal of a foreign tax credit for the taxes of the treaty partner country covered under the treaty, and will follow any treaty adjustment of source of income or characterization rules that are required to make the credit provision work.

As a collateral part of the credit mechanism employed by the U.S. (and in keeping within the U.S. statutory framework for application of the foreign tax credit) the treaties are drafted so that the income which the foreign country has a right to tax pursuant to the treaty will be treated as foreign source income for purposes of the credit. In a number of treaties, U.S. statutory source rules are imposed on the foreign country for determining the income the foreign country may tax. In some negotiations, however, the U.S. has accommodated to the treaty partner's rule on a particular item of income or there has been a compromise between the conflicting domestic source rules of the two countries and the treaty rule accordingly modifies the U.S. source rule. It should be recalled in this connection that because the U.S. uses the credit mechanism to relieve double taxation and not exemption, negotiation with the foreign country on the source rule is over which country will tax a certain activity or item of income and which country will give a credit. It is not a matter of both countries exempting the income. Nor does a U.S. taxpayer pay less total tax than the U.S. would charge the taxpayer in the absence of the treaty.

(3) *Treaty Rules Affecting the Treatment by Foreign Countries of U.S. Citizens, Residents and Corporations*

I would characterize U.S. treaty policy with respect to the provisions to be obtained from foreign countries with respect to U.S. citizens, residents and corporations as being intended to achieve non-discriminatory treatment of U.S. taxpayers and generally to reduce foreign tax burdens in excess of U.S. taxes on such taxpayers. As in the reciprocal case of foreigners doing business in or with respect to the U.S., the treaties are intended to facilitate the conduct of trade and investment by U.S. taxpayers overseas. Thus, exporters and contractors are to be assured of minimum requirements before they incur foreign tax liability and reduced rates of foreign withholding taxes lower foreign tax burdens not only to the benefit of U.S. taxpayers but also to the benefit of the Treasury, which probably gains much of its tax revenue on foreign source income from the reduction of foreign withholding taxes through treaty provisions.

Once a threshold test of significant business operations within a foreign country has been met, U.S. treaty rules follow the practice embodied in the Internal Revenue Code for more than sixty years and recognize the prior claim of the source country to tax the profits arising from such operations, but through the foreign tax credit mechanism the U.S. taxes the foreign income to the extent that the U.S. tax rate exceeds the foreign tax.

Non-discrimination is achieved both explicitly in a specific non-discrimination article and in the substance of other negotiated provisions, as in the case of tax treaties with countries having integrated tax systems. The U.S. has traditionally been an exporter of construction services and films and U.S. treaties contain specific provisions as to when such activities become taxable. U.S. treaties also contain reciprocal exemption provisions for shipping and aircraft and containers used in international traffic.

As discussed below, the United States, unlike most other developed countries today, does not utilize its tax treaties to provide incentives for investment in developing countries, which is an instrument of economic policy employed by Canada, France, Germany, the Netherlands, Japan and other countries.

(4) *Policy Issues in U.S. Negotiations with Developed Countries and Developing Countries*

(A) *Developed country negotiations.*—In the case of the developed countries, particularly those in Western Europe and Japan, there is a considerable degree of common ground between the U.S. and its treaty partners with respect to international tax rules. These countries share the perspective of being capital exporting countries and there is enough of a two way flow in trade and investment to encourage reciprocal tax provisions. While there are differences in the unilateral forms of double taxation relief between tax credit and exemption countries, there are closely shared views as to the origin of income and a common emphasis upon residence over source taxation.

In my judgment, the principal current international issue with Western European Countries (and it is an issue among them as much as between any European countries and the U.S.) is how the integrated corporate/shareholder tax systems being widely adopted as domestic tax law in Europe will treat foreign portfolio and direct investors. The U.S. treaties with France and the U.K. provide for extension of the domestic integration rules of those countries to U.S. individual portfolio investors. In addition, the recent U.K. treaty and, according to Treasury, a pending Danish treaty, partially extend the integration rules of those two countries to U.S. direct investors. The Commission of the European Economic Community correctly forsaw that discriminatory treatment of foreign investors under integration systems would be inconsistent with the economic objectives of the European Community, since such nationalistic integration rules, unless corrected, would distort investment patterns. The U.S. has argued that this concern about distortion should apply as well to bilateral treaty partners.

The development of appropriate rules for corporate/shareholder integration systems is a difficult challenge. To some extent it calls in doubt the traditional rules on reciprocal withholding rates when a country with a so-called classical system of separate corporate/shareholder taxes negotiates with a country that imposes tax at only one level.

There are other issues with countries that we generally consider to be in the developed country category. Among the more important of these questions is that of non-discrimination provisions. In that regard countries such as Australia and Canada have been reluctant to enter into non-discrimination rules as broad as those in the OECD Model.

(B) *Developing country negotiations.*—In the case of negotiations with developing countries, there is a basic difference in emphasis between the U.S. and the developing country. As capital importing countries, the developing countries emphasize source rather than residence taxation. They therefore have different rules than those of developed countries as to the deemed origin of income, withholding tax rates are frequently high, arm's length deductions are often disallowed for inter-company payments, and the threshold level of activity for imposing tax on a business is usually much less than is the treaty standard for taxation by developed countries.

There is also generally little concern by developing countries over the effect of the treaty rules on U.S. taxation of their residents investing in U.S. since they have no desire to improve the opportunity for foreign investment by their residents. Their perspective is one of either maximizing their source taxation revenues or, if they have investment incentives, seeking to insure that any tax concessions they make flow to the benefit of U.S. investors and are not merely a transfer of revenues to the U.S. Treasury.

Since the U.S. has not accepted treaty incentives for developing country investments by U.S. residents, developing countries have often felt that there was little reason to have a tax treaty and only a limited number of U.S. treaties with developing countries have entered into force. I believe the climate in this regard is in the process of change. Developing countries are attaching greater significance to standard treaty rules. There is a greater appreciation that the increased certainty associated with standard treaty provisions is itself a positive feature for the potential foreign investor. Developing countries have also become increasingly aware that the exchange of information and other provisions for cooperation with the Internal Revenue Service can benefit their tax administration and reduce their concern that their tax staffs may be unable to cope with multinational investment and more sophisticated tax rules.

The negotiating issues for developing countries can, therefore, be divided into two categories. The first category is the negotiation over conflicts in the detailed tax rules of the developing country and the U.S. The second category is the treatment of developing country tax incentives.

From a review of provisions of U.S. treaties that have been negotiated with developing countries, I conclude that in the first category of detailed rules where there have been past differences, the U.S. Treasury has now accepted provisions substantially similar to positions advocated in the guidelines prepared by the UN Group of Experts, including permanent establishment definitions with respect to ancillary services, agents, and insurance; interest and royalty withholding rates; treatment of equipment rentals; jurisdiction to tax capital gains; and taxation of shipping income. The substance of these rules is increased recognition of source country taxation rights and requires some modification from the U.S. treaty rules that would be imposed in treaties with developed countries. In addition, the U.S. has a policy with respect to withholding tax rates of not insisting that the developing countries reduce their rates below an amount that would be creditable under U.S. rules (even though lower rates would be sought from developed countries). The U.S. does seek reduction of withholding to a level that eliminates excess foreign tax credits.

In some areas, significant negotiating differences remain, such as source rules for the taxation of income from services, although the United States appears to be moving toward some change in its position on this question, which requires changes in U.S. source rules to avoid double taxation. Important issues will continue to remain open, of course, with those developing countries that are unwilling to accept rules similar to those of the UN guidelines. A continuing question is whether certain developing countries will move toward accommodation with the U.S. on source rules, non-discrimination provisions, and taxation on a net income basis with allowance of deductions for arm's length payments. Without some accommodation on the part of developing countries to adopt generally acceptable international tax standards, there is no point in having a treaty with them merely for the sake of having treaties.

The second important issue in negotiations between the U.S. and many developing countries remains the question of tax incentives for foreign investment. Undoubtedly the major issue between the U.S. and developing countries during the past 20 years has been the desire of a number of developing countries that the U.S. agree to "tax sparing" treaty provisions. From the standpoint of the developing countries the issue is whether their willingness to make a revenue sacrifice to encourage investment is going to be offset by a transfer of revenues to the U.S. Treasury, rather than a benefit flowing to the U.S. investor. The concept is a simple one. The developing country will reduce its tax rate on the income of the foreign investor and the residence country of the investor will either exempt such income from domestic tax or grant a foreign tax credit with respect to such income as if the foreign income tax had in fact been paid. A similar concept appears in the credit provided under section 936 of the Internal Revenue Code with respect to investment by U.S. persons in Puerto Rico.

In the 1950's, tax sparing treaty provisions were in fact entered into in several U.S. treaty negotiations. These provisions were rejected by the U.S. Senate. There is extensive literature available on this subject. In the Kennedy Administration in the early 1960's an alternative "incentive" was provided in several signed treaties which consisted of extending a form of the investment credit to investments in developing countries. These treaty provisions were also rejected by the Senate. No treaty containing tax sparing or investment credit provisions has been submitted since the early 1960's.

Although rejected by the U.S., the tax sparing concept has been the general international practice for treaties between developed and developing countries. While the exact terms vary from treaty to treaty, a 1979 survey indicates that tax sparing is a policy of Canada, France, Germany, Japan, the Netherlands, Norway, Sweden, and the United Kingdom, among other developed countries. Some of these treaties were negotiated by the developed countries independently of specific domestic statutory law authorization. Others were entered into pursuant to authorizing legislation. Germany, for example, has recently amended its foreign investment incentive laws and includes not only tax sparing in its treaty provisions but provides statutory tax-deductible reserves (100 percent for least developed countries and 40 percent for other developed countries) for investment in foreign production, the extraction of natural resources, commercial services (other than tourism), and agriculture or forestry. Additional reserves and current deduction of foreign affiliate losses against German parent company income are also permitted to encourage foreign investment. Such policies of developed countries encourage the expectation among developing countries of similar tax provisions in U.S. law or treaties.

There is a continuing issue as to whether the U.S. should offer tax incentives for investment in developing countries. Critics of tax sparing have argued that it is an undesirable or even foolish policy. This may not be necessarily the case in all situations. The widespread practice of the other developed countries to enter into such arrangements suggests that in general they have found such policy to be in their national interest, including securing access to markets and natural resources. The policy issue of whether treaty incentives (tax sparing or otherwise) are desirable is I believe worthy of continued U.S. consideration.

However, I do not believe that such incentive provisions are necessary for the satisfactory development of a U.S. tax treaty program with developing countries. My experience has been that given an adequate explanation of U.S. law and the general value of income tax treaties, there is a substantial basis for concluding treaties with developing countries. I believe that the present Treasury is actively pursuing treaties with developing countries on the basis of present U.S. law and that they are likely to meet with success. The process is slow, but I can foresee some breakthroughs.

I would emphasize in this regard that one fundamental part of U.S. international tax law remains critical to the potential for U.S. income tax treaties with developing countries, and, indeed, is of significance to our general relations with developing countries apart from treaty considerations. This is the fact that under the tax laws of the U.S. (as well as under the laws of all other developed countries), the foreign earnings of U.S. owned foreign subsidiaries that are not tax haven operations are not taxed by the U.S. until such earnings are repatriated to the U.S. This treatment of undisturbed earnings of foreign subsidiaries is viewed with great importance by developing countries. Occasional proposals to alter U.S. rules to tax such undistributed income attract immediate and deep concern, typified by the reaction of the chief negotiator of an important developing country that such extrerritorial taxation would be "an act of economic warfare".

I believe that given the present structure of U.S. tax law, the U.S. can and should work with the developing countries to find a basis for agreement on the detailed rules of day to day taxation. Such accommodation can be achieved in a manner quite consistent with the underlying provisions of the Internal Revenue Code, particularly following the development of the U.N. guidelines. There must, however, be some negotiating flexibility on both sides when it comes to details.

(*C*) *Tax havens.*— There is a third category of countries (overlapping both developed and developing country categories) that may be referred to as "tax havens". A country may consciously set out to provide tax benefits (usually tax exemption) an an intermediary for international investors or the tax benefits may be less consciously provided and result simply from the interaction of local and foreign laws. In either type of situation, the consideration for the U.S. tax treaty negotiator should be much the same. The basic objective underlying a treaty is to write rules that reduce the likelihood of double taxation. The basic treaty objective is not to eliminate all taxation. Thus, one should normally be negotiating with a country that also imposes tax and the objective will be to sort out who collects the tax and who gives double taxation relief. This requires investigation of the foreign country's law. A number of years ago the U.S. abandoned the practice of automatic extension of treaties to possessions and territories of foreign countries which contained the potential for tax haven abuses. Currently, the Treasury is reviewing the terms of and value of certain of those older treaties.

Basically tax havens should not receive tax reductions. They do offer, however, a prospect for exchange of information agreements and that possibility should be further explored.

With respect to the issue of "abuse" of tax treaties or treaty shopping, I suggest that the primary consideration lies in the Treasury's selection of treaty partners and diligence in reviewing the foreign country's tax system before negotiating U.S. withholding tax reductions. Bilateral modification of treaty provisions to account for subsequent changes in foreign (or U.S. laws) are appropriate and there is precedent for this. On several occasions foreign treaty partners (e.g., Canada and Switzerland) have amended their internal law to reduce the potential use of the treaty partner country as a conduit by third country residents. I understand that the Treasury is reviewing those few treaty arrangements that are heavily utilized as investment conduits and will, I assume, be proposing changes that it deems desirable.

Common sense should be applied in fashioning anti-abuse rules in tax treaties. If the objective of tax treaties is to contribute to the freedom of movement of capital, goods and persons, without the burden or influence of tax factors, it is important to exercise restraint and avoid adoption of encumbering procedural requirements in order to qualify for the benefit of tax treaties. Such requirements can defeat the purpose and utility of the treaty.

FORMULATION OF U.S. TAX TREATY POLICY AND TREATY PROCEDURES

I have been asked to comment on the role of Congress in treaty policy. There is no doubt that the Congress establishes the fundamental structure of United States income tax treaties by the provisions and policies of the Internal Revenue Code. As far as I am aware, the U.S. is the only country that inserts a rule in its treaties stating that, in general, taxation by the United States of its U.S. citizens and residents is unaffected by the treaty, except for the source of income and credit rules which are essential to the agreement in providing which country will tax certain income and which country will give double taxation relief and the taxes that will be recognized for this purpose.

As previously described, in the case of the taxation of non-resident aliens and foreign corporations, there are a greater number of departures from the Code in terms of reduced withholding tax rates and the threshold of activity for taxation. These treaty rules, which are generally reciprocal in form, with the treaty partner making similar modifications in its law, can fairly be described as limited modifications of U.S. law.

Thus, the treaty provisions are built entirely around the Internal Revenue Code and treaty rules of the U.S. Model that vary from the exact terms of the Code do so in interpretation of the spirit of those Code rules. Second, there is an institutional continuity built into the role of the Staff of the Joint Committee on Taxation as advisor both to the tax writing committees and to the Foreign Relations Committee when it considers tax treaties. In addition, the ultimate legislative authority resides with the Congress. There is no income tax treaty provision which cannot, in principle, be overturned by subsequent legislation by the tax writing committees and the Congress. It is important how this ultimate power is exercised. Since it is not an American notion that treaties are "mere scraps of paper", maximum care should be exercised when domestic tax policies are changed, requiring a change in a treaty rule (which most often will be the embodiment of a statutory rule). An apportunity should be accorded for the U.S. negotiators to re-negotiate treaty amendments, which is an acceptable and reasonable practice followed and understood by other countries.

Direct action on negotiated treaties has not been the role of the tax writing committees. Under the organization of our government the basic structure for international agreements that rise to the "treaty" status are negotiated by the Executive and put into effect upon obtaining the advice and consent of the Senate. A very broad range of international agreements are concluded in this manner, including agreements dealing with income and estate and gift taxes.

Review and comment on the U.S. Model Treaty, its relationship to the Code, and an inquiry into the objectives of U.S. treaty activity is a responsible role for the tax writing committees. The Oversight Subcommittee is particularly suited for this function and consideration can certainly be given to whether Cod rules could be made more harmonious with acceptable treaty practice. There are, of course, other possibilities, including drawing upon Congressional experience with the trade agreement procedure, including initial Congressional negotiating authorization and veto powers in each house. I am doubtful, however, that such a formal mechanism is really necessary or desirable as a practice for bilateral agreements.

If U.S. policy were to move toward a program of tax treaty incentives for developing country investment, as was proposed both by the Eisenhower and Kennedy Administrations, it might well be desirable to establish the ground rules though legislation authorizing the Executive to negotiate implementing agreements. I do not at this time think the treaties have that substantive an impact

I also believe that it is unrealistic to seek to restrict U.S. negotiators merely to incorporating the exact terms of the Internal Revenue Code in U.S. treaties, at least if the U.S. wants to join with other nations in a viable tax treaty program.

With respect to public participation in the negotiating process, I believe that there are practical limitations on what can be done beyond present procedures. The model from which the U.S. negotiates is a public document. Today public notice of pending negotiations, including certain topics of negotiation, is given with an opportunity for public comment on issues. The present Treasury has taken the helpful additional step of providing a briefing on pending issues at a proper point during negotiations, including specific problems that raise issues not covered by the U.S. Model. The public has little to object to if it does not make its position known before the treaty negotiation is completed. At that stage there still remains the process of public hearings and Senate debate on the treaty itself.

Mr. GIBBONS. Now the last witness, Carl Nordberg.

STATEMENT OF CARL NORDBERG, GROOM & NORDBERG, WASHINGTON, D.C.

Mr. NORDBERG. Thank you Mr. Chairman.

I am delighted to be able to accept your invitation to testify this morning. I will limit my testimony primarily to the observation that you made in the announcement of these hearings which was that even through tax treaties override or modify certain provisions of the code, the taxwriting committees of Congress have not been involved in the ratifying of them or even formulating the underlying policy of these international agreements. Actually it seems to me that it is not so much that these treaties modify the provisions of the code but rather they modify very important provisions of the Internal Revenue Code.

Also I would point out that these treaties are with the countries wherein the U.S. companies have the most investment and likewise the investment here in the United States is from countries with which we have treaties. So what I'm saying is that the Ways and Means Committee and the House of Representatives are not involved in a major aspect of the formulation of tax policy and the laws which impact on a substantial portion of the U.S. taxation of foreign operations.

I think at this point in my testimony you can determine that I am not completely in accord with all the rest of the witnesses that have spoken here this morning. I would like to see the treaty program returned somewhat to its rightful place. I think it is an important program. It should go forward but I don't think it should be expanded into areas where, in particular, you have problems involving major substantive issues.

In my view the absence of the involvement of the taxwriting committees has to some extent caused the program to suffer stagnation. The Senate Foreign Relations Committee and its staff just does not have the interest or the expertise to deal with tax treaties. They have great expertise and great interest in other issues but tax treaies have always been treated as stepchildren over there. They receive the lowest possible priority.

It took 4 years to get the United Kingdom treaty implemented and in large measure the delays were caused by the scheduling problems with the Foreign Relations Committee. I believe that if the taxwriting committees would get involved in this process there would be a broader interest and a greater interest in the treaty program and that would cause the program to move more quickly.

I think if people like yourself, Mr. Chairman, would become involved in the program you would not permit it to stagnate. As I mentioned before and I think David Brockway said, there are treaties there now that have been pending for 2 years. These treaties need to be moved along.

However, in my view the greatest adverse consequences of the current procedure whereby the taxwriting committees do not participate in this program, is that the taxwriting committees may develop one tax policy in an area and the Foreign Relations Committee may develop an altogether different tax policy and then the Treasury Department, because of this bifurcation, has to try to develop one policy to deal with the Ways and Means Committee and the Finance Committee and a different policy to deal with the Foreign Relations Committee.

Now the topic which is the hot topic today in international taxation here in the United States is the foreign tax credit. The chairman of the Senate Foreign Relations Committee has suggested that the issue involving the foreign tax credit should be solved in the treaties. I disagree and I disagree strongly. The treaty process is not the process or the proper forum for the consideration of the foreign tax credit issue or any other issue that is one of major tax policy.

I think the United States should have standard rules to implement their major tax concepts. For example, the availability of the foreign tax credit to a major U.S. industry should not depend on whether or not the United States has a treaty with a particular country.

Last June the Treasury Department issued a set of proposed regulations containing strict new rules for the qualification of the foreign tax credit under the code. While the Treasury Department does not agree with me, I will continue to interpret those rules and contend they provide that the tax systems of all the major producing countries of the world flunk the credibility tests of these proposed regulations with the exeception of Indonesia.

That means that the tax laws that apply to the extractive industries in Canada, the United Kingdom, Norway, Egypt—you pick the countries—are no longer creditable under the proposed regulations. However, the same Treasury Department that drafts proposed regulations providing that the United Kingdom's petroleum revenue tax is not creditable also drafts a treaty that provides that that very same tax is creditable. Likewise they have drafted a proposed set of regulations that provide that the Norwegian tax is not creditable but then along comes a treaty that will provide the Nowergian tax creditable.

Now, I would like also to point out that while the U.K. treaty was on the Senate floor one of the Senators pointed out that if the treaty made the PRT a creditable tax it would be possible to use what some people referred to as excess credits developed by the PRT against non-United Kingdom source income. You may recall that this is not an original thought. The Treasury Department raised these arguments in presenting amendments to the Internal Revenue Code to the Ways and Means Committee just last year.

It is not surprising then that when the Senator parrotted the Treasury Department's refrain about excess credits, the Treasury Department immediately agreed to amend the treaty and the treaty has been amended so as to provide a limitation which is very much the same in result as the type of limitation amendment which is now pending before the Ways and Means Committee and has never been enacted. Therefore, the limitation which is pending before the Ways and Means Committee may be a thing of the future but as far as the taxpayers paying the PRT are concerned the limitation is a reality. I would also point out that I would expect that the Norwegian treaty will have the same type of limitation provision.

Now if one believes that the Treasury Department's new foreign tax credit regulations on extractive tax are sustainable and I obviously do not, then the United States has one foreign tax credit concept for countries that we have treaties with and a different concept for the rest. And I submit that there should be one concept in this area and it should be one concept which is developed by the tax-writing committtees, not by the Senate Foreign Relations Committee.

We currently have a tax policy regarding extractive taxes that is based on three rules. The first rule is that a foreign extractive tax is generally not be to recognized as a creditable tax. The second rule is a foreign extractive tax is generally to be extended creditability in a treaty. And the third rule is that if creditability is extended in a treaty a new limitation even more restrictive than that in the current provision of the code will be applied.

I submit that this is a policy of confusion. I have a client that operates in Indonesia, the United Kingdom, and Nigeria. Now it is the view of the Treasury Department that the taxes that my client pays to Indonesia are creditable under the Internal Revenue Code and the limitations provision of the code apply. The taxes that the client pays to the United Kingdom, the PRT, the Treasury Department says that those taxes are not creditable under the code but they are creditable under the treaty and that the limitations provisions of the code don't apply, the limitations of the treaty apply. With respect to Nigeria they say that that tax is not creditable under the code. We don't have a treaty and therefore that tax is not creditable under any circumstances and of course the limitation provision in that circumstance is irrelevant.

Now, before I conclude let me clarify my position on the creditability of taxes like the PRT and the Norweigian profit tax. I think both of these taxes are income taxes and I think they qualify as income taxes under the Internal Revenue Code. Therefore, I think the provisions that have been added to the treaties are irrelevant because, as has been mentioned here time and again, the provisions of the treaty cannot take away a benefit extended by provisions of the code.

One of the questions we were asked is how the Ways and Means Committee or this subcommittee could get involved in the treaty process. I thing meetings like this is how the committee gets involved in the treaty process.

Mr. Rosenbloom has indicated a willingness on the part of the Treasury Department to provide this committee and the full committee with all the information they want to know about tax treaties so I think all you need to do is ask and you will be provided as large a role as you would like to have.

I hope that the number of facts and figures and concepts that have been thrown at you this morning will not dissuade you from continuing your interest in this program.

Thank you.

[The prepared statement follows:]

STATEMENT OF CARL A. NORDBERG, JR.

I will limit my testimony primarily to the observation made by Chairman Gibbons in the announcement of this hearing: "Even though tax treaties override or modify certain provisions of the Code, the tax-writing committees of Congress are not involved in ratifying them or even formulating the underlying policy for these international agreements."

Actually, it isn't that these treaties just modify provisions of the Code; they modify very significant provisions of the Code. Also, and most importantly, these treaties have been made with the countries wherein most U.S. investment has been made, and those same foreign countries have also been the source of most foreign investment in this country. In other words, the Ways and Means Committee and the House of Representatives are not involved in a major aspect of the formulation of the tax policy and laws which impact on a substantial portion of the U.S. taxation of foreign operations.

In my view, the absence of the involvement of the tax-writing committees has caused the treaty program to suffer from constant stagnation because the Senate Foreign Relations Committee and its Staff have little expertise in the field of international taxation and even less interest, in comparison to other matters under that Committee's jurisdiction. As a result, tax treaties—even those of major significance such as the U.K. Treaty—are accorded low priority. It took more than four years to complete action on the U.K. Treaty and much of the delay was the difficulty in scheduling its consideration by the Senate Foreign Relations Committee.

However, in my view, the greatest detriment of the current procedures is that while the tax-writing committee may have established one tax policy in an area, the Senate Foreign Relations Committee may have an altogether different policy and, because of this bifurcation, the Treasury Department will have separate tax policies responsive to the tax-writing committees and the Foreign Relations Committee.

The topic these days in U.S. international taxation which has most peoples' attention is the foreign tax credit. The Chairman of the Senate Foreign Relations Committee has suggested that tax treaties are the proper vehicles for resolving this issue. I strongly disagree. The treaty process is not the proper forum for the consideration of the foreign tax credit issue or any other major tax policy issue. The United States should have standard rules to implement tax concepts of significant importance. For example, the availability of the foreign tax credit to a major industry should not depend on whether or not the United States has a treaty with a particular country.

What is the U.S. Treasury Department's policy on the foreign tax credit, and how is this reflected in recent treaties? Last June, the Treasury Department issued a set of proposed regulations containing strict new rules for qualification. While the Treasury Department does not agree, until proven incorrect, I will continue to contend that, under those proposed regulations, with the exception of Indonesia, none of the producing countries' extraction taxes are creditable. As a result, the taxes paid on extractive income in the United Kingdom, Norway, Egypt, Nigeria, the Philippines and Peru are no longer creditable under the Code.

However, while the Treasury Department drafted proposed regulations under which the United Kingdom's Petroleum Revenue Tax (P.R.T.) would not be creditable, the Treasury Department also drafted a treaty which provided that the United Kingdom's P.R.T. was creditable. While the Norwegian petroleum tax would not be a creditable tax under the proposed regulations, it is also understood that the treaty being negotiated by the same people who drafted the regulations will provide creditability to the Norwegian petroleum tax.

It should also be noted that while the United Kingdom Treaty was on the Senate floor, one Senator pointed out that, if the United Kingdom P.R.T. is a creditable tax, it would be possible for U.S. taxpayers to use excess P.R.T. credits against non-United Kingdom source foreign oil income. You may recall that the alleged ability to misuse excess credits was part of the argument for some foreign tax credit amendments suggested to the Ways and Means Committee last year. It was not surprising, then, that when the objecting Senator parroted the Treasury refrain on the misuse of "excess credits", the Treasury Department announced to the Senator and the Senate that they would amend the Treaty so as to, in effect, add a foreign tax credit limitation which would have substantially the same result as the Treasury amendment which had been suggested to the Committee on Ways and Means. The limitation amendment is still pending before the Committee but it is a reality now for U.S. taxpayers who pay the United Kingdom P.R.T. It can be expected that a similar limitation will be added to the Norwegian Treaty even though it is clear that the Committee on Ways and Means has not yet decided to alter the foreign tax credit limitation. In other words, while the Ways and Means Committee has not yet decided to change the tax policy in this area, the Treasury Department, with the concurrence of the Senate Foreign Relations Committee, has done so.

If one believes that the Treasury Department's foreign tax credit rules on extractive taxes are sustainable, and I do not, the United States now has one foreign tax concept for countries that are willing to negotiate a treaty, and a second concept for all the rest. I submit there should be one concept and that one should be developed by the tax writing committees.

We currently have a Treasury policy on extractive taxes that consists of three rules.

The first rule is that foreign extractive taxes are generally not to be recognized as creditable taxes under the Code.

The second rule is, foreign extractive taxes are generally to be extended creditability by treaty.

The third rule is that if creditability is extended by treaty, a limitation provision even more restrictive than that in the Code is to be applied.

I submit that this is a policy of confusion. I have a client that operates in Indonesia, the United Kingdom and Nigeria. It is the view of the I.R.S./Treasury that: (1) The tax paid Indonesia is creditable under the Code and the limitation provisions of the Code control; (2) the P.R.T. paid the United Kingdom is creditable under the Treaty and the special limitation provisions of the treaty apply; and (3) the tax paid Nigeria is not creditable and, therefore, the limitation provisions are irrelevant. If a foreign tax deserves to be treated as a creditable tax for U.S. tax purposes, it should obtain that status from the Internal Revenue Code, not from a tax treaty.

Before I conclude, let me clarify my position on the creditability of taxes such as the United Kingdom P.R.T. and the Norwegian Profits Tax. In my view, they are both creditable under the Internal Revenue Code; the provisions of the proposed regulations to the contrary are incorrect. Therefore, as to those taxes, the the provisions of the treaty are meaningless because a treaty cannot deprive a U.S. taxpayer of the benefits of a provision of the Internal Revenue Code.

Some people have asked how the Ways and Means Committee could become involved in tax treaties since they are the prerogative of the Senate. I suggest that with respect to treaties of consequence such as the Norwegian, Israeli or Egyptian Treaties, this Subcommittee ask for a public briefing on issues under negotiation and the tentative positions which have been adopted, and then hold a public hearing. If the Subcommittee disagrees with what the negotiators are doing, the Subcommittee could make its position known to the Treasury. After a treaty is signed, this Subcommittee could hold another hearing and if you did not like what was done, you could suggest that it be renegotiated. A Committee or Subcommittee does not need formal authority to impact on a subject area, particularly when the area is one which should be within the Committee's purview. I submit that this Subcommittee and the Committee on Ways and Means can have much involvement in tax treaties as they desire.

Mr. Gibbons. Thank you, sir.

Mr. Rosenbloom, last year, in August, I wrote you a letter asking for an analysis of our present treaties and I got back a three-page letter from you that was very general and contained really very little analysis. The joint committee staff has provided this committee with a draft pamphlet that runs some 20 pages, a pamphlet I understand Treasury has some objections to. What I would like to hear from you is why is Treasury taking such a lackadaisical attitude toward our request for analyses? When do you expect to complete your review of the joint committee's draft of their paper?

Mr. Rosenbloom. Mr. Chairman, first of all I really don't believe that the Treasury has taken a lackadaisical view because your letter—which I believe was addressed to Mr. Lubick—the preparation of a response was done in my office and I did review it. I don't have the letter with me because I was not aware you were going to ask about it specifically but at the time I rather thought it did answer your questions.

The joint committee staff has prepared a draft that deals with particular treaties—and now, by the way, I would like to point out that we are only talking about oil and gas extraction. We shifted the inquiry away from tax treaties to a particular subject under tax treaties. We are not holding back the preparation of the joint committee pamphlet. We would not be in a position to prevent the staff of a congressional committee from preparing whatever Congress desires.

We were asked for our comments on the pamphlet and we provided our comments. In very general terms, Mr. Chairman, we believe that it is not a wise idea to take what appears to be or could be interpreted to be a hard and fast legal opinion on some of these issues, which are quite complicated, which involve a great deal more underlying material than I think the joint committee staff has had time to research, and I believe they would concede that, and we have some doubts about the wisdom of a pamphlet which might decide legal issues, particularly when that would be to the detriment of taxpayers.

We provided our comments to the joint committee staff. We are not in position to prevent them from doing what Congress wishes them to do with the document. We do not necessarily agree with what they have said and insofar as we are concerned we would be prepared, I think, to try to give you more details on similar questions but if we were to undertake such a project, Mr. Chairman, in my view it would be quite a vast undertaking. I think it would be necessary for reasons that have been discussed today to go back to each of the treaties that you are talking about and really try to figure out what were the prevailing authorities at the time and undertake the process of issuing a ruling in much the same way that the Revenue Service would.

Finally on that point what you are really talking about here is an Internal Revenue Service function and not a function of the Treasury, namely to interpret existing U.S. law. The process of administering tax treaties is not one that the Treasury Department does and in order for us to say anything or to give any information that would really be useful, we would have to try to secure the agreement of the Service, so I think it is a major undertaking but we are not preventing joint committee staff from cooperating with you to the full extent.

Mr. Gibbons. We have called on representatives of your office and representatives of GAO concerning problems GAO had encountered in reviewing activities of the competent authority in IRS because of treaty secrecy clauses. I wrote to Treasury in mid-December and urged that you expeditiously resolve the matter and report to me no later than January 31, 1980. Virtually no progress has been evidenced and no response has been received.

Could you tell me when we will get a response to that?

Mr. Rosenbloom. Certainly, Mr. Chairman.

You are quite right. You did of course write to us on this matter and you did meet with members of my staff and the GAO on this matter, but where I don't think you are correct is in saying there has been no progress. In fact there have been a number of meetings and telephone conversations between us and the GAO. In many of them I have not participated personally so I can't account for precisely where the matter is today, but I have personally talked to GAO on more than one occasion and I can tell you generally what I understand to be the status of that issue.

I believe it should be possible for the Internal Revenue Service—again, this is an Internal Revenue Service matter you are talking about, it is a matter of tax administration—to cooperate to a very large extent with the GAO. And I think the GAO understands that and as far as I know they are proceeding with information that they have been able to obtain from the Revenue Service.

There are some problem areas. Those problem areas, Mr. Chairman—I am glad you asked this question because I think we should focus on them. The problem that the IRS has in turning over certain items of information to the GAO is that they are afraid that doing so will not be understood by our treaty partners and will have the effect of decreasing the flow of information to the United States.

I don't think that is a result that you want, Mr. Chairman, and it certainly is not a result that we want, so there has to be some kind of a reasonable path taken that will provide GAO with as full a picture as possible of these matters without jeopardizing our opportunity to obtain the information we need.

Mr. GIBBONS. In December I wrote the Treasury concerning the renegotation of the tax treaty with the Netherlands Antilles. As I pointed out it is my understanding that notice of our intent to terminate this treaty must be given before June 30, 1980, if the termination is to be effective in 1981. Otherwise we can't terminate until 1982. I don't know why we want a treaty with the Netherlands Antilles at all. We certainly should not have one until they agree to clean up the abuses and fully exchange information with us.

What are we going to do if these conditions are not satisfactorily negotiated by June 30 of this year?

Mr. ROSENBLOOM. Well, Mr. Chairman, this is a subject that we discussed in some detail when I appeared before this subcommittee last year. Since that time we have initiated negotiations with the Netherlands Antilles. And I think it fair to say that we have had quite serious and lengthy conversations on the whole range of issues embodied in the U.S. model and embodied in our particular treaty relationship with the Antilles.

At this point we are scheduled to meet again with the Antilles prior to June 30 of this year. I would imagine since the meeting is likely to be a substantial one that at its conclusion we should have a pretty clear idea of where we may be headed. Now, whether, if the conclusion of these negotiations is unsatisfactory, there remains enough time before June 30 to terminate the treaty if we should want to do that—I am not really certain whether there remains enough time. I would answer that Congress always could override the treaty if it felt it necessary to do so.

I would also point out since the treaty has been in effect since 1948, the need to change or terminate it promptly, a need with which I agree by the way—may be overridden by the desire to have orderly negotiations and to play that string out before we make a responsible decision on the treaty relationship.

Mr. GIBBONS. Why don't you just tell them you are going to terminate and then let them come in and talk?

Mr. ROSENBLOOM. Well, I don't think that where we are today, Mr. Chairman, is very far from that state of affairs.

Mr. GIBBONS. Will it take legislative action to terminate this treaty prior to 1982 if we don't act by June 30?

Mr. **Rosenbloom.** Yes.

Mr. **Gibbons.** Also, I wrote IRS in December of 1979 about the administration of the present treaty. Would you explain the administration's current view as to whether the U.S. corporation that establishes finance subsidiaries in the Antilles is eligible for favorable tax relief?

Mr. **Rosenbloom.** I am sorry to give the same answer repeatedly to you, Mr. Chairman, but it is a fact that that question is squarely within the jurisdiction of the Internal Revenue Service. I think that I can give you some information though. It is probably possible in some cases for Americans to form companies in the Netherlands Antilles and secure the benefits of the treaty for those corporations. Whether the companies that are currently in existence achieve that result or not is a matter to be assessed on a case-by-case basis and it is my belief—but I am not in a position to confirm this definitely—that the Internal Revenue Service is looking into some of those corporations and in appropriate cases I would expect they would propose a denial of treaty benefits, but I think it is really a case-by-case situation rather than a blanket statement.

Mr. **Nordberg.** Could I make one comment. I would like to say that I doubt very much whether one could establish a finance subsidiary in the Netherlands Antilles and obtail all the treaty benefits in as easy a fashin as possibly your earlier witness indicated. I don't think major U.S. corporations follow that kind of practice and there are a lot of tax lawyers in this town that will not give opinions on Netherlands Antilles finance subsidiaries including this lawyer.

Mr. **Rosenbloom.** That is correct. The issue requires assessment on a case-by-case basis. There is no assurance of an easy route for obtaining treaty benefits today.

Mr. **Gibbons.** What is the purpose of the IRS revenue procedure 79–40, which requires U.S. withholding agents to seek a ruling before withholding at the reduced rate allowed in the Antilles treaty?

Mr. **Rosenbloom.** The treaty provides a denial of the 5 percent rate on certain dividends, a reduced rate at source for direct investment dividends, unless the relationship between the recipient and the subsidiary was arranged and maintained for the purpose of obtaining the treaty benefit.

The concept behind revenue procedure 79–40 and the ruling requirement is to allow the Revenue Service to police the "arranged and maintained" test which derives from the treaty.

Mr. **Gibbons.** Professor Ault, what do you think would be the cost-benefit ratio of repealing the withholding tax on interest?

Mr. **Ault.** I think it would cost a lot and not benefit very much.

Mr. **Gibbons.** Would you explain that in more detail?

Mr. **Ault.** This is on the legislative proposal?

Mr. **Gibbons.** Yes.

Mr. **Ault.** I think that the benefits are difficult to quantify when you take into account the fact that for foreign country governments investing in the United States there is no withholding tax. For treaty country investors investing in the United States there is no withholding tax. What we are really talking about is international tax avoiders that we have heard so much about today coming into the United States and I don't think this is necessarily a benefit to have their money.

We are also talking about money possibly coming from less developed countries and as I indicated the less developed country position is usually that they don't want us in treaty negotiations to reduce our withholding rates. Why should we do it unilaterally? Thus as to the benefits, it seems to me that they are not going to be great and the costs, as I indicated, in equity, are going to be substantial. You in effect are saying to the U.S. taxpayer who has his money in a savings account that the interest is going to be subject to tax, but you say to the foreign investor in the less developed country or the foreign investor with the trust in Liechtenstein that when he invests his money here—he does not pay any U.S. tax at all.

When I do a cost-benefit analysis on that basis I don't have too much trouble with where I come out.

Mr. Gibbons. Mr. Rosenbloom, what would be your response to that?

Mr. Rosenbloom. Well, Mr. Chairman, as you know, a proposal to eliminate the withholding tax on interest was proposed.

Mr. Gibbons. That is right.

Mr. Rosenbloom. You may also recall in my testimony here last year I suggested the reasons for having at least a relatively low tax on interest at source. The administration had previously supported the withholding tax proposal. We asked to take another look at it in light of the administration proposal which we regard as of much greater magnitude to have a withholding system with respect to domestic taxpayers.

Essentially—to answer your question more directly—the amount of money we collect under the interest withholding tax is currently small, very small. It probably is in the range of $25 million a year, maybe somewhere in excess of that, but as matters go, it is much less than we collect under the dividend withholding tax, for example.

There have been arguments asserted that if we eliminate the interest withholding tax there will be a vast flow of moneys into the United States and that will be very good for the process of capital formation in the United States. On the other hand, some people have responded that if we are only collecting relatively small amount of tax now there does not appear to be a serious impediment to the inflow of capital and it may seem a little strange that eliminating $25 million of tax can produce on the order of $6 to $7 billion of increased investment which some people would claim.

That is to say relieving, eliminating the U.S. tax on interest paid to foreigners is—first of all it has long been U.S. treaty policy to do it with major developed countries of the world, to do it reciprocally. Second, I would doubt, given our interest in capital formation, that we would want to impose a serious tax on interest because I think it would make us noncompetitive in international capital markets and I think for purely nontax reasons I would argue against doing that.

And in light of those constraints it seems to me that the present situation, where we have a nominal tax in the statute, with exceptions that make the statute look like swiss cheese, is really the worst situation of all. We should go one way or the other. We should either impose a tax on interest, or we should relieve the tax on interest.

But to have a tax of 30 percent on interest in the code and then have historically based exceptions that have arisen over time creates all sorts of anomalies, unfairness, and inefficiencies.

Mr. **Gibbons**. Don't you think we ought to trade off that for something in the tax treaty negotiations?

Mr. **Rosenbloom**. That would be an argument for retaining it in negotiations, but I think that the kinds of proposal that we were talking about, Mr. Chairman, would not have relieved the withholding tax on interest paid by subsidiaries of foreign corporations to their foreign parents, which is a major tax treaty consideration anyway. So even the proposal that was being considered would have left something important for treaty negotiations.

Mr. **Gibbons**. Why should we have tax treaties with countries that have no income tax? What is the effect of that?

Mr. **Ault**. I don't think we should, Mr. Chairman.

Mr. **Gibbons**. We have it with the U.S.S.R. and with Eastern bloc countries.

Mr. **Rosenbloom**. They all have income taxes, Mr. Chairman.

Mr. **Gibbons**. The U.S.S.R. has income tax?

Mr. **Rosenbloom**. Yes. It has an income tax on its own citizens at a relatively low rate.

Mr. **Nordberg**. Even China has an income tax, Mr. Chairman. People don't know about it.

Mr. **Gibbons**. I wish I didn't know about ours. So the answer is they all have income taxes.

Mr. **Rosenbloom**. We have one treaty with a country with no income tax, Antigua.

Mr. **Gibbons**. Why do we have a treaty with it?

Mr. **Rosenbloom**. When you ask the question "why," Mr. Chairman, the answer is very often historically based. The United Kingdom treaty of 1945 was extended to various U.K. territories.

Mr. **Gibbons**. So it is a historical accident.

Mr. **Rosenbloom**. In my opinion there is probably no subsisting justification for having a treaty with a country with no income tax.

Mr. **Gibbons**. Do we have a tax treaty with the Caymans?

Mr. **Rosenbloom**. No.

Mr. **Gibbons**. Why? Obviously there are abuses that go on down there.

Mr. **Rosenbloom**. Historically, I am not certain why. When the U.K. treaty was extended it was not extended to the Cayman Islands but there was picking and choosing at that time and Treasury might have declined to extend it.

Mr. **Patrick**. My belief, which is hearsay from others, was that at the time of possible extensions, the British Government indicated the United States-United Kingdom treaty need not be extended to the Cayman Islands because it did not meet a requirement that they have a substantially similar tax to the United Kingdom.

And the Cayman Islands does not have one. Why that was not picked up in Antigua I don't know.

Mr. **Gibbons**. Dr. Spitz would like to volunteer an answer.

Mr. **Spitz**. There is an answer to that question and that is Antigua does have tax at the rate of 40 percent. In the case of the Cayman Islands, at the relevant time there was no such place as the Cayman Islands other than as a dependency of Jamaica. Therefore it did not come up for discussion before the British Government at all.

Mr. **Rosenbloom.** My information is that a recent Antigua Government eliminated the income tax. I would defer to Mr. Spitz if he has immediate and direct knowledge. I am not in constant contact with all the British territories on this subject.

Mr. **Gibbons.** Mr. Rosenbloom, why are we dealing with Cyprus and Malta? What is the purpose of this? I don't have anything against them.

Mr. **Rosenbloom.** That is a very fair question, Mr. Chairman.

Mr. **Gibbons.** I am not picking them out. I am trying to understand better this whole process.

Mr. **Rosenbloom.** First of all, there is one answer that applies to both of them. In my view and I think in a view of the Treasury going back some time, there is a benefit in extending the U.S. tax treaty network to developing countries. The United States has, because of the tax-sparing and investment tax credit debates that raged in this country in the 1950's and 1960's, very few treaties, independent treaties, with developing countries.

In fact we had only two, with Trinidad and Tobago and Pakistan, prior to the new one with Korea which just went into effect. Now there is sort of a domino effect, if you will, in negotiations. The more treaties you have with developing countries the easier it is to get additional treaties with developing countries.

Therefore, it has been our view, it has been our policy generally speaking, that we would negotiate with any country that was seriously interested in talking with us as long as it was not a tax haven. Now Malta is not, generally speaking, a tax haven. Malta wanted to talk to the United States. There has been a treaty pending with Malta, treaty negotiations pending with Malta, since the early 1970's. Those negotiations broke up because the Maltese insisted upon tax sparing. They were resumed fairly recently at their insistence and then, with them having insisted, we proceeded to finalize a treaty.

It closely follows the U.S. model and I can't see that it does any harm. It may do some benefit for the United States. Cyprus is a different story. In regard to Cyprus there was significant U.S. investment in Cyprus at the time those negotiations were begun. We had a substantial mining operation in Cyprus and there is still a potential for additional investment in Cyprus of some size once political stability is assured on that island.

We signed a treaty with Cyprus, concluded negotiations and were prepared to send up a treaty to the Senate in the early 1970's. However, because of the unsettled political condition on Cyprus that treaty was shelved by the State Department until only fairly recently, at which point it felt, we were told, that the reasons for holding up the treaty no longer applied. We had a signed treaty then. Why don't we proceed with it? The difficulty with proceeding with it as it stood was that in the interim Cyprus had become a tax haven. It was not when we originally started negotiating with them. We returned to the negotiating table and tried to put in as many protective provisions as possible to try to avoid the abuse of that treaty once it goes into effect.

That is the story on Cyprus and I might say we will presumably get information from them and that can only be to our benefit.

Mr. GIBBONS. Mr. Heftel.

Mr. HEFTEL. Mr. Rosenbloom, Mr. Nordberg has suggested that Treasury has two tax policy responses, one for the Foreign Relations Committee and one for the Finance and the Ways and Means Committees. He feels that the Finance and Ways and Means Committees should originally be involved in determining tax provisions of treaties. How do you feel about his proposal and observation?

Mr. ROSENBLOOM. Yes; Mr. Heftel.

First of all I would observe that Mr. Nordberg's remarks were limited, so far as I could tell, to the taxation of foreign oil and gas income. Now although that is a very important subject for the United States, it is only one part of the tax treaty problem.

Mr. HEFTEL. Mr. Nordberg, were you originally referring to oil and gas interests in your observation?

Mr. NORDBERG. With respect to my observations on the foreign tax credit, that is correct.

Mr. HEFTEL. On the overall policy questions?

Mr. NORDBERG. My remarks were intended to be broader than the issue of the creditability of extraction taxes, but that issue is of major importance from whatever perspective it is considered. However, my basic point is that I would like to see our policy on important tax issues. That is what I am saying.

Mr. ROSENBLOOM. Mr. Heftel, I don't think there are necessarily two different Treasury policies. We have an Internal Revenue Code against the backdrop of which treaties are negotiated. Treaties, largely for historical reasons, are dictated by international standards. The United States tried for a time, as my prepared statement indicates, to enforce its statutory law on the rest of the world. We found it very tough sledding indeed.

Mr. HEFTEL. I would assume so.

Mr. ROSENBLOOM. In regard to oil and gas extraction, I don't think the divergence is really nearly as dramatic as Mr. Nordberg presented it and certainly I do not think Treasury is speaking out of both sides of its mouth simultaneously. However, we have several questions to address.

One is what does the Internal Revenue Code say. The Internal Revenue Code contains rules for determining which taxes are creditable and what are the limitations for use of those taxes. We are in the process of preparing regulations involving the interpretation of what taxes are creditable for purposes of the Internal Revenue Code. We have also made a statutory proposal to the tax-writing committees involving the limitation of credits for oil and gas extraction income.

We are hopeful we can achieve some kinds of solution of both of those questions as a statutory matter in the not too distant future. I would come back in this regard to something Mr. Brockway said, which is that oil and gas extraction income is very largely not a treaty matter. The major producing countries of the world, most of the major producing countries of the world, are not countries with which, unfortunately, we have treaties. And so we do need statutory rules.

We have to be clear on what the rules are. When you come over to the treaties it seems to me that there is quite a different matter and I don't want to now pass upon who should have jurisdiction over treaties which I think is very largely the prerogative of the Congress but it does seem to me that it is a different question when you sit down to negotiate with another country, and the purpose after all is to eliminate double taxation of income from that country, and they are saying to us: look, here is income in the United Kingdom and you say our tax is not an income tax but we say it is an income tax and this is, in our view, an international difference warranting resolution. It seems to me not illegitimate in that context and using very strict limitations to avoid double taxation of income from that country and nothing else, to achieve an agreement whereby the income from that country will not be doubly taxed—that is the purpose why you have somewhat different rules in the treaty context than you might have in the code.

The code paints a broad picture for use with all countries. The treaties, as I see it, provide the necessary refinement on a country-by-country basis. I don't think it is possible as a statutory matter to address all the multitude of tax systems that we encounter throughout the world.

Mr. HEFTEL. Should the tax-writing committees be involved in the ratification process rather than the Senate Foreign Relations Committee? Isn't it true that that committee is not conversant with the subject matter and would be inclined to use a tax treaty as a bargaining chip without knowing the consequences of the bargaining?

Mr. ROSENBLOOM. Insofar as consultations with the tax-writing committees are concerned I have absolutely no problem with that and indeed I think de facto that goes on today. Historically, it may be of some interest on this point that the way your objective was accomplished was by having cross membership on the Finance and Foreign Relations Committee.

This issue that you are referring to arises basically because such cross membership, as I understand it is no longer possible.

So the mechanism at the member level for information exchange is missing. There is still information exchange at the staff level because the very same staff serves both the Foreign Relations Committee in regard to tax treaties and the tax-writing committees. But for me to say that it would be appropriate for the Senate to realine its jurisdiction so that these treaties which do in some cases have a foreign relations component—for them should be assigned to Finance rather than to Foreign Relations, I think it would be presumptuous to make a recommendation on that.

Mr. HEFTEL. More important, though, should the tax provisions be a product of input from the tax-writing committees rather than the foreign relations committees?

Mr. ROSENBLOOM. I definitely think the tax-writing committees should have an input in these matters. Someone mentioned today that the hearings today are a good first step in that direction.

Mr. HEFTEL. But obviously it is a step in a direction that, it has been suggested, we should have already adopted going back in time, and we are very late in the game and still have not accomplished that objective.

Mr. NORDBERG. I would like to point out one thing, Mr. Heftel: Earlier, when David Brockway was testifying on the role of the joint committee staff in the treaty process, or the lack thereof, if you listen very carefully to David Brockway's answer, he did not indicate that they play a very significant role. In fact, they play a very limited role in advising the Foreign Relations Committee, and I suggest to the committee that I do not think that the cordination between the Treasury Department's treaty negotiation teams and the joint committee staff on treasury policy is one of great moment.

I was on the joint committee staff. I served there for 4 years as the person who was supposed to receive this input. It was largely nonexistent.

Now, I will say that in recent years it is better but nevertheless it is not a significant amount of input.

On the other point, on the creditability of extraction taxes, like PRT and Norwegian tax, there is a great difference in treaty policy and code policy. I would like to point out that this divergence is presented notwithstanding that the treaty's purpose is to avoid double taxation, and the the same is true of the Internal Revenue Code provision. Also, the issue of creditability of there issues is very important. The basic intention of sections 901 and 903 is to avoid double taxation, and I would also point out, until June 1978, or at least up through 1977, the petroleum revenue tax of the United Kingdom would have been treated as a creditable tax by the Treasury and IRS. Therefore, we would not have this problem with the treaties, and the same thing would have been true, in my judgment, of the Norwegian tax. So, I think the problem that exists between Mr. Rosenbloom and myself is a question of the legitimacy of those proposed regulations and, basically, we just disagree.

Mr. GIBBONS. Mr. Rosenbloom, did you want to respond?

Mr. ROSENBLOOM. Well, quickly, neither the Norwegian tax nor the United Kingdom tax go back very far in time, so they are recent problems.

I don't really think that I could add much on the regulations. I do agree with Mr. Nordberg, our dispute is over the regulations. We are constrained in adopting regulations by statutory language.

The treaty process provides and is intended to provide a degree of flexibility with particular countries which it seems to me should be an instrument of U.S. policy.

Thank you.

Mr. HEFTEL. Thank you.

Mr. AULT. I would like to comment on that.

I think I am about halfway between the two of you. I agree that it is appropriate in an ambiguous situation to use the treaty to qualify tax which at least would be questionable under the internal standards of the code and the regulations.

I think it would be inappropriate to use a treaty to give credit for a tax which clearly was not an income tax under the statutory provisions. I think there should be some flexibility in the treaty process to resolve ambiguous questions.

But I don't think the treaty process is appropriate for making major changes in creditable taxes for the reasons we have been talking about this morning, the way treaties get ratified and the way the process works. I don't think it is appropriate for making major changes in the taxation of U.S. taxpayers.

Mr. ROSENBLOOM. I can accept that, Mr. Chairman.

Mr. NORDBERG. Would you provide foreign tax credit for Israeli loans?

Mr. AULT. I am concerned more with the principle. I don't think this is the proper forum to focus on specific issues of credit gifts.

Mr. GIBBONS. What is this Israeli loan? I am not familiar with that.

Mr. ROSENBLOOM. Israel had, but has now eliminated, a provision in its law requiring taxpayers to make certain forced loans or giving them the option to make certain forced loans in lieu of taxes to the Israeli Government.

The original treaty negotiated by the Treasury Department and sent up to the Senate in 1975 included a foreign tax credit for those forced loans.

Mr. HEFTEL. You are saying the amount of the loan?

Mr. ROSENBLOOM. The amount of the loan, the taxpayer paid over an amount he was forced to pay as a loan.

Mr. HEFTEL. That full amount?

Mr. ROSENBLOOM. He was allowed a credit with appropriate provisions for a readjustment when the loan was repaid, but in the interim it was in essence—I think you could say it was like a loan from the U.S. Government to the Government of Israel.

Mr. GIBBONS. And then the intermediary was the American taxpayer?

Mr. ROSENBLOOM. Correct. One could debate that situation at great length, but the short of the matter is that that treaty was withdrawn from consideration by the Senate Foreign Relations Committee before it held its hearings in July 1977. And for that and other reasons, we went back to Israel to renegotiate.

We have negotiated a protocol to the treaty and insofar as forced loans are concerned, all we did in the renegotiated protocol is to allow the credit for the very few taxpayers subject to preexisting loan arrangements; but the Israelis have phased out that provision of their law, and there is no ongoing credit for forced loans now in the Israeli treaty.

Mr. HEFTEL. Mr. Patrick, you expressed concern over situations in which the American taxpayer is a resident of a foreign country and has a problem with the double taxation on interest on investment income in the United States.

Could you amplify that as to scope and recommendations?

Mr. PATRICK. I think one can say in terms of scope, it is probably a very widespread phenomenon and one that has only recently been the subject of attempted solution in trying to work out the double taxation problem that is involved. To state briefly what happens is to take, for example, the U.S. citizen who is taxable on his worldwide income and certainly on his investment income without any code exemption—there is limited exemption for earned income—who moves in connection with his job or teaching to Canada. Canada, like virtually every country in the world, including the United States, imposes taxation on the income of a resident. This U.S. citizen is now a resident in Canada and a country like Canada, or the United States, taxes worldwide income of the resident.

At this point one would say the United States provides a foreign tax credit for foreign tax on the income of a U.S. citizen; however, we provide the tax credit under the code only to the extent that the foreign tax is on foreign source income under our rules.

In this case, the citizen residing in Canada has income that is clearly U.S. source income; it is a bank account in the United States, or stock that he has in a company he works for, and therefore, there is no foreign source income.

At this point the problem is that he is being taxed by Canada and he is being taxed by the United States. The U.S. tax, moreover, is not that imposed upon a Canadian resident in the form of a withholding tax, but a tax imposed on the net income of a U.S. citizen. Canada is not prepared to give a treaty tax credit to the U.S. citizen who is there as a Canadian resident in a manner that would be any different than from their taxing any other Canadian resident just because he is also a U.S. citizen.

You have an issue between the citizenship principle of taxation and a residence principle of taxation, and the question is, how do you sort this out.

Mr. Rosenbloom would be a good one to explain the exact mechanics, but in the protocol entered into last year with France, there is an effort to take the tax liability that would be incurred in the two countries and to allocate different segments of the investment income—first, let the United States tax it as if we were taxing any French resident on a withholding basis. Above that, France could tax a portion of the income on a residence basis, and the United States would give a credit for that French tax, and if there is any residual tax or potential tax liability, depending on rates, the United States gets the final, residual tax.

It is clearly a certain complication for the taxpayer, but it is a method of trying to eliminate a particular double taxation problem.

In my opinion, it is a very good example of why treaties are needed to permit some refinements in what is a basic rule we have, that we tax citizens worldwide and that we give foreign tax credits.

There is the question of a reasonable basis for letting each side feel it was satisfied in taxing a portion of the income, and the other country giving some relief for it. Was it equitable as far as other residents or citizens similarly situated were concerned? That is the problem. That is a difficult one, but I think they have achieved one solution in the French context.

Mr. Heftel. Mr. Rosenbloom, would you care to comment?

Mr. Rosenbloom. Yes. Mr. Patrick's description is basically accurate. I would say this is a fairly broad issue that we have encountered in treaty negotiations.

The United States taxes citizens worldwide on a citizenship basis. Increasingly, as countries' tax systems have become more and more sophisticated, they have questioned whether the U.S. claim to a tax on a citizenship basis should come before their claim to tax on a residence basis, and it is rather difficult to maintain that our claim, which is in many respect more tenuous than the claim of the residence country, should take precedence for purposes of primacy of tax.

So, we have in the French protocol changed the source of certain items of income to allow our American citizens resident in France to avoid what would be quite a substantial double tax problem.

Mr. **Heftel.** Is this matter being handled through regulatory means, rather than legislative, do you think, to the satisfaction of our taxpayers in foreign countries?

Mr. **Rosenbloom.** I think it has to be handled by treaty, really, Mr. Heftel, because there is nothing in our statutory law that would permit us to change the source.

For example, Mr. Patrick mentioned Canada. Under the current treaty with Canada, my understanding is that we do not have anything that allows us to change the source, and neither does our statutory law. So, what we need to resolve the double taxation problem is a treaty provision.

On the other hand, I would be reluctant to see legislation broadly addressing the problem, because in those countries which don't insist on a primacy to tax on a residence basis, I don't see why we should unilaterally concede.

Mr. **Heftel.** Are you satisfied through your regulatory means and the treaties that you are negotiating that you are addressing the problem to your satisfaction from the standpoint of the taxpayer?

Mr. **Rosenbloom.** When a taxpayer is subject to double taxation in another country in this magnitude, and with this degree of assurance, we hear about it quickly.

Mr. **Heftel.** But do you feel you are acting on it in a manner satisfactorily for resolution?

Mr. **Rosenbloom.** Yes. The French protocol is satisfactory to the Americans in France. Canada is the next problem area and we are working hard to try to get a new treaty there.

Mr. **Heftel.** Mr. Chairman, I regret not having been here for all the testimony, but I certainly want to applaud the depth of knowledge and concern evidenced by the panel.

I thank you very much.

Mr. **Gibbons.** It has been an excellent panel.

Mr. Rosenbloom, we have more questions for you in writing. We hope you could give them urgent attention.

Mr. **Rosenbloom.** I will do my best.

[The information follows:]

Office of the Secretary of the Treasury,
Washington, D.C., July 30, 1980.

Hon. Sam M. Gibbons,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Washington, D.C.

Dear Mr. Chairman: In your letter of June 13, 1980 you asked a series of questions concerning the tax treaty policy of the United States. My answers are enclosed.

We appreciate your interest in this subject and your efforts in seeking to obtain information and views which will assist in developing United States tax treaty policy. We would be very pleased to continue to work with you and your staff in this important task.

Sincerely,

H. David Rosenbloom,
International Tax Counsel.

Enclosure.

Question 1. The U.S. Model Income Tax Treaty, in Article 16, contains a measure designed to block treaty shopping abuse. This provision has been criticized as raising potentially difficult administrative problems in identifying the shareholders of the foreign company and determining their tax status under local law. This measure has been incorporated into six U.S. income tax treaties. What has Treasury's administrative experience been with this provision? Have reduced withholding rates been denied under it, or have unsuccessful attempts to deny them been made? What alternative anti-abuse measure could be used?

Answer. Article 16 provides that the benefits of reduced withholding rates at source on dividends, interest, and royalties are not applicable when (1) the recipient corporation, a resident of the other country, is at least 25 percent owned, directly or indirectly, by individual residents of a country other than that country, and (2) special tax measures apply in that other country, which reduce its tax imposed on dividend, interest, and royalty income from the country of source substantially below that generally applicable to corporate business profits.

There are seven U.S. treaties in force containing provisions analogous to Article 16 of the U.S. Model. Six are generally in the form of Article 16 (Finland, Iceland, Korea, Norway, Trinidad and Tobago, the United Kingdom); the seventh (Luxembourg) is somewhat different, but has a similar effect.

We have been advised by the Internal Revenue Service that there have been to date no cases involving denial of treaty benefits under these provisions. This is not surprising. We seek to include a holding companies provision in every U.S. income tax treaty, even when there are no special internal law provisions in the law of the treaty partner that would trigger application of the holding companies provision. Moreover, one can reasonably expect that the presence of such a provision will discourage investors from entering into transactions that, because of the provision, would not benefit from the treaty. (We are advised, for example, that this is widely true with respect to Luxembourg.)

We seek to include a holding companies provision in all income tax treaties for two reasons: to protect against changes in the tax laws of treaty countries that would open up the treaties to abuse; and to provide a clear precedent for inclusion of such a provision when negotiating with a country that does have special measures in its tax law that would trigger the denial of treaty benefits.

There are, clearly, problems in the application of Article 16. Potential difficulties in administration are presented because IRS must rely largely on information provided by the treaty partner (although the "tax status" of "shareholders of the foreign company" is not relevant). Such information may often not be available, even with the best of intentions on the part of the other country. There may be no way to identify the ultimate shareholders of a corporation when there is a chain of corporations interposed between such shareholders and the corporation that receives income from the United States.

Moreover, Article 16 may also be considered defective, at least in some respects, as a policy matter. It deals only with certain types of treaty shopping and is applicable only where a special favorable tax regime applies in the other country. Where, for example, the recipient corporation is subject to normal corporate tax rates but is able, by paying large amounts of deductible interest, royalties, or other amounts, to reduce its tax base substantially, Article 16 is ineffectual. Such "conduit companies" may pay very little tax to their country of residence but are not subject to attack under Article 16. Similarly, if a country has no "special measures" but imposes its general tax at a very low rate, Article 16 does not apply.

On the other hand, Article 16 may operate to deny treaty benefits in cases where denial is not intended and may not be appropriate. For example, a corporation resident in a country which exempts, or essentially exempts, foreign source dividends from tax as a means of avoiding double taxation would fail the test of Article 16 and thus be denied U.S. treaty benefits. This is not an abusive situation.

There are alternative rules which may be used in particular circumstances to limit some forms of treaty abuse. Care must be taken, however, to avoid penalizing "legitimate" third country investment though a treaty country (including investment through the United States and into our treaty partners).

One approach, used in the pending U.S.-Cyprus treaty, is to make the tests in Article 16 (25 percent foreign ownership and "special measures") alternative rather than cumulative. On this approach treaty benefits are denied if either the corporation receiving income from investments in the other country is owned to the extent of 25 percent or more by persons who are not residents of the same country as the corporate investor, or if special measures apply to the corporation's income from sources in the treaty partner. Under this provision, conduit companies as well as "special measures" companies would be covered.

A second approach, found in Swiss internal law and several Swiss treaties with European countries, attempts to deal with the conduit problem by focusing on payments made by the company receiving income and claiming a treaty benefit in the country of source. Under this approach a corporation which is owned to a substantial extent by nonresidents would not be entitled to treaty benefits if its deductible expenses exceeded a specified percentage of its treaty favored income or if its dividends paid were less than a specified percentage of its income.

A third approach, proposed for a new treaty with the British Virgin Islands, is to insist in all cases on relatively high rates of withholding tax at source on dividends, interest, and royalties, coupled with preservation by the United States of the right to impose "second withholding taxes" on dividends and interest. This is the simplest approach of all. It does not focus on specific types of abuse and try to correct them, nor does it rely upon information to be furnished by the treaty partner. Rather, it removes, or substantially reduces, the benefits of treaty shopping.

There are, however, costs in adopting this approach as a general U.S. tax treaty policy. With respect to most countries, the U.S. is a net capital exporter and, thus, a net recipient of investment income. U.S. investors and the U.S. Treasury would bear a substantial cost in increased foreign tax credits if this means of limiting treaty abuse were adopted generally. This approach, therefore, should be used with caution.

It is worth noting, in this connection, that there are other provisions in the U.S. Model, in addition to Article 16, which are aimed at preventing treaty abuse, including treaty shopping. Paragraph 6 of Article 4 applies to a country that taxes foreign source income on a remittance basis. Treaty benefits are granted by the United States in such a case only with respect to income which is remitted, since only then would double taxation exist.

Articles 10, 11, and 12 of the U.S. Model, dealing with dividends, interest, and royalties, limit source country reductions in tax to cases where the beneficial owner of the income is a resident of the other country. The "beneficial ownership" rule is designed to prevent third country residents from enjoying reduced rates of withholding tax through the use of a treaty country nominee. Paragraph 4 of Article 26 commits each Contracting State to collect such amounts as may be necessary to ensure that relief under a treaty does not ensure to persons who are not residents of the treaty partner. Several countries, notably Switzerland, collect taxes from nominees under such a provision and remit such taxes to the United States.

Question 2. Please describe the anti-abuse and exchange of information provisions incorporated in the recently negotiated income tax treaties with Cyprus and Malta.

Answer. Paragraph (6) of Article 4 (Fiscal Residence) of the treaty with Malta contains the "remittance basis" rule which denies otherwise available relief in the country of source to unremitted income. Article 16 (Investment or Holding Companies) is similar to Article 16 of the U.S. Model. Reduced rates of tax at source on dividends, interest, and royalties are denied if a company resident in a Contracting State is owned, directly or indirectly, to the extent of 25 percent or more by individuals who are not residents of the same country and such country applies "special measures" to reduce its tax on the dividends, interest, and royalties below the tax it would impose on corporate business profits. Paragraph (5) of Article 8 (Shipping and Air Transport) supplements the principles of Article 16 by limiting the exemption from United States tax at source on shipping profits for corporations resident in Malta but owned by persons not resident in Malta to those which establish that such profits are subject to Malta tax without the benefit of any special relief from such tax under incentive provisions of Malta law.

Article 27 (Exchange of Information) contains provisions similar to the U.S. Model, the OECD Model, and other recent U.S. income tax treaties. These provisions allow the U.S. and Malta to exchange tax return information and authorize requests for information in the form of documents admissible in court.

The treaty with Cyprus contains, in paragraph (5) of Article 4 (General Rules of Taxation), the remittance basis concept. Paragraph (6) of the same Article contains a rule denying a reduction of tax at source if the recipient, a person other than a corporation, is resident in the other State and is subject to a tax burden in that other State "substantially less than" (less than 50 percent of) the tax burden that would be imposed by that State if he had earned the income from sources within that State.

Article 26 (Investment or Holding Companies) represents a variation upon Article 16 of the U.S. Model. A reduction of tax in the country of source is denied for dividends, interest, and royalties if either the tax in the country of residence on such income is "substantially less than" (less than 50 percent of) the tax generally applied in that country on corporate profits or 25 percent or more of the capital of the recipient corporation is owned, directly or indirectly, by individuals not resident in that country (or, in the case of a Cypriot corporation, who are citizens of the United States). Paragraph (4) of Article 10 (Shipping and Air Transport) denies the exemption at source available to a corporation resident in the other Contracting State earning shipping or air transport profits if 25 percent or more of the shares of the corporation are owned, directly or indirectly, by individuals not resident in such State (or, in the case of a Cypriot corporation, who are citizens of the United States).

Article 28 (Exchange of Information) contains exchange of information provisions similar to those of the U.S. and OECD Models. The exchange of information provisions in the Cyprus treaty apply to taxes of every kind imposed at the national level.

Question 3. Your prepared statement implies that you would prefer to eliminate "treaty shopping" abuse by renegotiating tax treaties with those countries that foster such practices rather than an across-the-board legislative prohibition. Is that your position? How long do you anticipate the renegotiation approach will take?

Answer. I do not necessarily prefer to eliminate "treaty shopping" abuse by renegotiating treaties rather than by an across-the-board legislative prohibition. Renegotiation is a slow and tedious process. However, I am skeptical about legislation dealing witih "treaty shopping" because it is hard to imagine any solution which will deal with this complex problem in a way that will be, at one time, fair, reasonable, and effective. The difficulty is that each tax treaty jurisdiction presents independent considerations and it is therefore difficult to envision a sound legislative approach that treats each jurisdiction appropriately.

"Treaty shopping" is dependent upon: (1) treaty relief from statutory withholding taxes at source on income (particularly dividends, interest, and royalties) paid to residents of the treaty partner (including resident corporations owned by third-country persons); (2) imposition of a low tax burden by the treaty partner on such income; (3) freedom from treaty partner withholding taxes on income (particularly dividends, interest, and royalties) paid by its corporate residents to residents of other countries. In some situations, treaty shopping can be possible through a combination of factors (2) and (3), plus freedom from the U.S. "second withholding taxes" on dividends and interest paid by corporate residents of the treaty partner to residents of other countries. Depending on variations in these factors, some countries exhibit a high potential for treaty shopping while in others the potential is low. In some countries nontax factors (such as exchange controls) or non-income tax factors (such as capital taxes) tend to discourage treaty shopping. On the other hand, some nontax factors (bank secrecy) undoubtedly attract treaty shoppers.

Even among those jurisdictions where the treaty shopping potential is high, the appropriate response can vary. For example, some countries, like Luxembourg, have relatively high tax rates, which are reduced substantially for certain companies. In such cases, much of the treaty shopping problem can be addressed by denying treaty benefits to such companies. The response should perhaps be different for a jurisdiction such as the British Virgin Islands, whose general tax rate is extremely low. In such cases, higher across-the-board treaty withholding rates than the U.S. generally favors would appear desirable.

A legislative prohibition could deny the necessary flexibility to grant treaty benefits where appropriate to treaty country corporations owned by third country residents. Only a few jurisdictions appear to exhibit a high potential for treaty shopping. The Treasury Department has discussed the problem of treaty shopping with many of these jurisdictions, and has initiated negotiations with several. We intend to pursue this matter as expeditiously as our resources permit.

Question 4. On July 27, 1979 (T.D. News Release B–1757), Treasury solicited comments by September 14, 1979, as to whether certain U.K. territories to which our old 1945 U.S./U.K. Tax Treaty had been extended were exploiting the treaty by permitting abusive "treaty shopping." The United States also requested the U.K. to advise U.K. territories that we desire to renegotiate the 1945 U.K. treaty still in effect with them to reflect the principles of the new U.S./U.K. Tax Treaty. What was the gist of the comments Treasury received? What is the status of our renegotiation of the 1945 U.S./U.K. Tax Treaty with U.K. territories? What policy objectives does Treasury have with respect to these countries and British territories?

Answer. The Treasury Department received four public comments in response to its solicitation of September 14, 1979, concerning the U.K. territories and former territories with which extensions of the 1945 tax treaty with the United Kingdom remain in effect. The gist of the comments was that: (1) elimination of treaty shopping would have an adverse impact on foreign portfolio investment in the United States; (2) any attempt to prohibit treaty shopping should not be directed toward particular countries or toward less developed countries generally; and (3) the use of treaties by third country residents, rather than constituting an abuse, serves the fundamental purpose of income tax treaties by mitigating double taxation between competing tax systems.

We are proceeding with reassessment of the treaty relationship with the U.K. territories and former territories. The United States has recently signed a new comprehensive treaty with Jamaica. We have conducted negotiations with the British Virgin Islands and hope to conclude by the end of this year a new treaty which eliminates any significant potential for treaty shopping. Negotiations with Barbados have been scheduled tentatively for later this year. Although the other U.K. terrorities and former territories do not seem to be used at the present time for substantial treaty shopping, the Treasury Department is contacting all of these jurisdictions with a view to reconsidering, and perhaps terminating or modifying, these treaty relationships. We have not yet received responses from some of these jurisdictions.

The Treasury's primary policy objectives are to modernize the treaties and curtail treaty shopping without unnecessarily upsetting U.S. relations with the U.K. territories and former territories.

Question 5. Revenue Procedure 79–40 requires that U.S. withholding agents seek a ruling before withholding at the reduced rate provided by the U.S./Netherlands Antilles Tax Treaty. What is the purpose of the ruling? Some commentators believe that the ruling requirement is invalid. Is the ruling requirement being widely ignored? Please provide the number of ruling requests made under Revenue Procedure 79–40. Should the Code or regulations be amended to remove any question of invalidity of the ruling requirement?

Answer. I am grateful for this question, which provides me with an opportunity to correct an inaccurate response that I gave to an oral question at the Subcommittee hearing on April 29, 1980. Revenue Procedure 79–40, like its predecessor, Revenue Procedure 66–40, requires a ruling to establish in certain situations that an Antilles corporation qualifies for reduced rates of U.S. taxation at source on dividends, and exemption from U.S. tax at source on interest and royalties.

The 1963 Protocol with the Antilles substantially precluded corporations, limited partnerships, and other entities which are residents of the Antilles from obtaining reduced U.S. withholding rates if the Antilles resident benefits from special reduced rates of tax in the Antilles. The Protocol restriction, however, contains two exceptions under which treaty benefits relating to dividends, interest, and royalties are allowed despite special low-tax provisions of Antilles law: (1) if all the stock of the Antilles resident is owned by Dutch corporations or by individual residents of the Antilles or the Netherlands; or (2) if the Antilles resident owns at least 25 percent of the stock of the U.S. payor corporation and less than 60 percent of the gross income of the U.S. corporation is derived from specified types of passive income.

To implement the provisions of the 1963 Protocol, Revenue Procedure 79-40 requires withholding at statutory rates on dividends, interest, and royalties unless the withholding agent is given: (1) a certificate from Antilles tax authorities stating that the Antilles resident is not entitled to the special low-tax benefits of Antilles law; (2) a certificate from Antilles tax authorities stating that the Antilles resident is owned by Dutch corporations or by Antilles or Dutch individual residents; or (3) an IRS ruling to the effect that the Antilles resident owns at least 25 percent of the stock of the U.S. payor corporation and that less than 60 percent of the gross income of the U.S. corporation is derived from specified types of passive income. Thus, the Revenue Procedure requires a ruling from the IRS only if the recipient seeks to claim the benefits of the third exception mentioned above. In other cases, the benefits of the treaty with respect to dividends, interest, and royalties are available if a certificate from Antilles tax authorities is obtained. (The difference in procedure is based on a recognition that the facts necessary to support the third exception are verifiable within the United States.)

The ruling requirement is termed invalid by some commentators apparently because it is stricter than the requirements of the regulations issued in 1955 under the Netherlands treaty as extended to the Netherlands Antilles. Under the regulations, an IRS ruling was required only of an Antilles corporation claiming the 5 percent withholding rate on dividends from a U.S. subsidiary. Regulations are not, however, the only way to implement income tax treaties. The Revenue Procedure explicitly states that it is intended to supplement the regulations and to reflect the treaty modifications made by the 1963 Protocol. I do not believe that either an amendment to the Code or a change in the regulations is necessary to validate the Revenue Procedure.

The ruling requirement of Revenue Procedure 79-40 is not widely ignored. There have been 23 ruling requests even though the period of time since publication of Revenue Procedure 79-40 has been relatively brief and the circumstances in which an IRS ruling must be obtained are limited. Most Antilles residents covered by the 1963 Protocol who receive dividends, interest, and royalties at the beneficial rates provided in the treaty do not need an IRS ruling because they are able to submit to the U.S. withholding agent one of the two certificates described above issued by Antilles tax authorities.

Question 6. It has been suggested that all of our tax treaties should be extended to U.S. overseas territories. What are the revenue implications for the U.S. and for the territories separately? Would such extensions create the potential for the use of such treaty extensions by the territories to make themselves tax havens?

Answer. No U.S. tax treaty in force extends to U.S. territories or possessions. The reasons for this are twofold: first, it is not a simple matter to achieve such extensions of U.S. tax treaties. Since the territories and possessions have independent tax systems, with legal provisions different from those of U.S. law, it would not be practicable simply to include the territories within the treaties' coverage. Special provisions are required to create a direct relationship between the treaty partner and the affected possession or territory. Second, the possessions and territories have not displayed much enthusiasm for participating in the U.S. treaty network. Recently, the Treasury Department invited Puerto Rico to discuss with Canadian officials the possibility of extending the new tax treaty with Canada to Puerto Rico. Although Puerto Rican officials initially expressed interest in such an extension, Puerto Rico has not yet determined whether it would be in its interests to participate on terms that would be satisfactory to Canada. In addition, at the suggestion of the Danish government, the Treasury inquired whether the Virgin Islands wished to enter into a tax treaty relationship with Denmark. The Virgin Islands declined to enter into such a relationship.

The revenue implications of including possessions and territories in treaties with other countries would probably be minimal. For the United States it is difficult to perceive any implications at all. For the territories the implications would vary from treaty to treaty and territory to territory. Generally speaking, the treaty interests of the possessions and territories are not the same as those of the United States. As a developed country, the United States favors residence basis taxation and limited taxation at source. Most developing countries prefer higher general taxation at source, and seek to attract investment through tax incentives. The tax policies of possessions and territories are thus more closely aligned with those of developing countries than with those of the United States. Reciprocal reductions of tax at source could be unsatisfactory for the territories but perfectly acceptable to the United States.

The relationship between the United States and the possessions and territories is, of course, governed by statutory law and not by treaty. While there is some tax haven potential in that statutory law, it would not be enhanced by participation of the possessions and territories in U.S. tax treaties. Present statutory law appears to permit certain U.S. possessions and territories to adopt policies similar to those of some tax haven treaty countries' which would enable them to serve as conduits for investments into the United State. We are not aware, however, that this is presently occurring.

Participation in a U.S. treaty by a U.S. possession or territory could, in some circumstances, create a potential for it to become a tax haven with respect to investments in the treaty partner. Presumably, other countries would assess such potential before agreeing to an extension of a U.S. tax treaty to a U.S. possession or territory.

Question 7. Both Marshall Langer and IRS Commissioner Jerome Kurtz stated at the Subcommittee's April, 1979 hearings, that they favored placing the use of treaty reduced withholding rates on a refund basis. Commissioner Kurtz indicated that increased revenues would offset the administrative costs. Should we revise our administration of tax treaties to require treaty users to file for refunds?

Answer. The Treasury Department believes that the present procedures for obtaining reduced withholding rates pursuant to tax treaties should be changed to increase compliance. Whether the change should be to a full "refund" procedure, or to an expansion of the "self-certification" procedure to cover dividends, is currently under study. Under a full refund procedure, withholding would be at the statutory rate and the reduced rates accorded by the treaties would be available only upon an application for refund by the affected foreign investor. Under the self-certification procedure, currently employed with respect to interest and royalties, the reduced rates would be available upon an initial certification by the foreign investor of his status. With respect to dividend income we we now use an "address" system, under which withholding is at reduced treaty rates if the address of the dividend recipient is in a treaty country. The "address" system is not satisfactory, but a "refund" system may not be the only workable option. We are seeking to determine whether a refund system is the best alternative.

Question 8. What is Treasury's policy with respect to estimating the revenue impact of tax treaties sent to the Senate for ratification? Can such estimates be prepared in detail with acceptable accuracy?

Answer. When possible, we make estimates of the revenue impact of treaty provisions. Although it is not possible to prepare accurate, detailed, estimates for each feature of each treaty, we can make estimates for certain important aspects.

We can, for example, for our major trading partners, use data compiled by the Commerce Department to estimate the revenue impact of changes in withholding rates at source on dividend, interest and royalty payments on direct investments. Since direct investment (10 percent ownership or more) typically accounts for the largest share of incoming investment income of U.S. residents, this data gives an important measure of the revenue foregone by another country in reducing its withholding rates by treaty. (This is not necessarily the same as a revenue increase to the U.S. Government, since an important objective of the treaty rate reductions is to reduce foreign taxes, irrespective of the foreign tax credit limitation.) On payments from U.S. sources to foreign residents, we also have detailed information from returns filed by U.S. withholding agents on payments subject to U.S. withholding. The effect of special provisions can also sometimes be estimated from industry sources. Typically, the estimates reflect existing behavior and do not assume changes due to the treaty.

Although these estimates are useful in weighing the balance of treaty provisions, as a general rule the net revenue gain or loss from treaties is believed to be modest. It is considerably less important than the avoidance of tax barriers to investment and trade caused by double or excessive taxation.

Question 9. It has been suggested that a way to cut treaty shopping would be to cut all statutory withholding rates to approximately the average treaty rates. Marshall Langer argues that nearly 90 percent of all income paid out of the United States to foreign persons goes through treaty countries anyway. What objections are there to this idea?

Answer. While cutting statutory withholding rates to some extent (and with respect to some items of income in particular) is desirable, it is doubtful that a cut to the average U.S. treaty rates for each type of income payment would substantially reduce treaty shopping. There is considerable variation in the maximum rates of tax at source in U.S. tax treaties, particularly on interest, royalties, and dividends. Those U.S. treaties which are currently used for treaty shopping tend to be below the average rates, at least with respect to some, if not all, items of income. Furthermore, there are provisions of some U.S. treaties in addition to limitations on withholding rates at source—for example, the waiver of the so-called "second withholding taxes" on dividends and interest—which make certain jurisdictions attractive for treaty shopping. Thus, while any reduction in U.S. taxes at source would eliminate some of the incentive for treaty shopping, reducing statutory withholding rates to the average U.S. treaty rates would still leave open many opportunities.

Treaty shopping would cease to be a serious problem if the United States reduced its statutory withholding rates to the lowest treaty rate for each type of income—i.e., to zero on interest and royalties, to 5 percent on direct investment dividends, and to 15 percent on portfolio dividends. Treasury supports such a statutory reduction in the rate applicable to portfolio interest, but statutory reductions of this magnitude across the board would seriously undermine the ability of the United States to obtain reciprocal benefits by treaty. The Treasury Department believes that a broad network of tax treaties is in the best interest of the United States and that there is no substitute for a policy of dealing wih each jurisdiction on its own merits.

Question 10. It has been suggested that the Internal Revenue Code be amended so that the withholding rate be increased from 30 percent to a higher percentage on payments made to residents of countries that will not, within five years of the date of enactment of the amendment, enter into exchange of tax-related information agreements with the U.S. What is the Treasury Department's reaction to this suggestion?

Answer. This suggestion does not appear meritorious. The existing 30 percent statutory rate is sufficiently high to induce countries to enter into agreements with the United States; those countries which refuse to enter into agreements with the 30 percent rate in effect would be unlikely to agree if the rate were increased. Moreover, residents of countries that refuse to enter into agreements can presently utilize our existing treaties with other countries to avoid the statutory withholding taxes on income paid from the United States. A higher statutory rate could be similarly circumvented.

Any treaty under which the 30 percent tax would be reduced would be likely to deal with information exchange. Agreements to exchange tax information exist with all jurisdictions having tax treaties with the United States (except the U.S.S.R.), and exchange of information remains an essential part of U.S. tax treaty policy. Whether such provisions function effectively is another question. As I mentioned in testimony before the Subcommittee in April 1979, this question is probably of greater significance in the case of tax haven treaties than the question whether an agreement to exchange information exists on paper.

Question 11. The recent U.S./U.K. income tax treaty eliminates the U.S. foreign insurors excise tax imposed on certain British insurance companies. Comparable measures have also been included in several other recently negotiated tax treaties, but in those treaties the exemption does not extend to reinsurance. Why is the U.S./U.K. treaty different? In a recent Treasury announcement, the public was informed of the intended renegotiation of the U.S./Belgium income tax treaty. It was noted in the announcement that the elimination of the U.S. foreign insurors excise tax would be one issue in the negotiations. What are Treasury's policy reasons for including these provisions in recent treaties? Why do you view this expansion as an appropriate area for broadening the scope of treaties?

Answer. Five current U.S. income tax treaties (United Kingdom, France, Romania, Hungary, USSR) include the section 4371 excise tax on insurance premiums as a covered tax, under two different approaches. One approach, typified by the recent protocol to the treaty with France and currently being taken in U.S. treaty negotiations, provides an exemption to a resident of the treaty partner if the U.S. risk is not reinsured with an enterprise which is not entitled to a similar exemption under the treaty or another U.S. tax treaty. This does not mean that "the exemption does not extend to reinsurance"; the exemption, whether for insurance or reinsurance, is lost if the risk is reinsured with a person not entitled to exemption from the tax. The purpose of the language is to deny the use of the treaty to conduit companies established in a treaty country but owned by residents of countries which do not enjoy a treaty exemption from the excise tax.

A second approach, typified by our recent tax treaty with the United Kingdom, permits an exemption to a resident of the treaty partner irrespective of whether the U.S. risk is reinsured with a person not entitled to exemption from the excise tax. This treaty was negotiated before we became fully aware of the potential "conduit" problem. We have raised the matter with the United Kingdom and have been assured that United Kingdom insurance laws effectively preclude third country residents from establishing conduit companies to take advantage of the treaty exemption.

The taxability under section 4371 of a premium paid for reinsurance of a U.S. risk to a person not entitled to treaty benefits is not precluded under either approach. Whether the reinsurance of a U.S. risk by either a French or a United Kingdom insurance company with, say, a resident of Germany (where the pertinent tax treaty does not cover the section 4371 tax) is subject to the excise tax is a question of U.S. statutory law.

The Treasury's reason for covering the section 4371 tax in income tax treaties is the same as its reason for covering U.S. income taxes—to avoid double taxation. The section 4371 tax is, in effect, a tax in lieu of an income tax. Section 4371 and its predecessors were enacted to reach foreign insurance companies which were frequently not subject to U.S. income taxes on their income from insurance of U.S. risks. Section 4371 ensures that, under statutory law, a foreign insurance company insuring a U.S. risk is subject either to income tax on its premium income or to the excise tax. If the foreign insurer is engaged in trade or business in the U.S., it is subject to U.S. income tax. The excise tax is typically applicable to companies not engaged in business in the U.S. Thus, the question whether the section 4371 tax should be covered in a tax treaty intended to relieve double taxation is very similar to the question whether the United States should insist upon source basis taxation of, for example, interest paid to nonresidents. If the treaty partner subjects the income of the foreign insurance company to tax, and if the treaty partner would not tax premium income of a United States insurance company at source in comparable circumstances, then the traditional United States preference for low source basis taxation should extend to the section 4371 tax. If the section 4371 tax is not covered in a treaty, double taxation of the foreign insurance company may result because the treaty partner may refuse to give credit either because the section 4371 tax is an excise tax or because technically it is imposed on the insurance transaction and not on the insurance company.

Question 12. There is some question as to whether Section 894(a) of the Internal Revenue Code renders inapplicable such anti-avoidance Code provisions as Section 269 to transactions involving tax treaties. Would amendment to the Code to ensure application of all of its anti-avoidance provisions to tax treaty enforcement be of assistance in halting treaty abuse? In the same vain, it has been suggested that the Code be modified to provide a better coordination of treaty and Code rules. Specifically, what changes do you recommend or think should be considered?

Answer. In certain situations, an issue might arise involving harmonization of section 269 with section 894(a) or, indeed, with underlying treaty provisions requiring reduction of, or exemption from, U.S. tax. We are not, however, aware of any cases in which such an issue has been litigated.

Generally speaking, section 269 is not the most effective anti-abuse statute, and it probably merits reexamination. Such reexamination could well include the implications of sections 269 for situations involving treaty abuse. This is certainly one available approach toward the type of "across-the-board legislative prohibition" raised in your question No. 3. Accordingly, the reservations which I expressed in response to that question would apply also in this context.

With respect all the anti-abuse provisions in the Internal Revenue Code, the "saving clause" contained in all U.S. tax treaties explicitly preserves the right of the United States to tax United States citizens and residents as if the treaty were not in effect. In regard to foreign persons, many abuse possibilities are covered by explicit anti-avoidance provisions in the treaties. We perceive no particular difficulties arising from section 894(a).

I believe that better coordination of Code and treaty rules is desirable but that it will require a sustained and substantial effort over a period of time. Currently, the Code and U.S. tax treaties employ somewhat different standards and rules. Some of the differences are inherent in the difference between a statute and a convention designed to reconcile the rules of the United States and the treaty partner. But some of the differences are probably unnecessary and the issue has never been adequately examined. Presently, because our tax treatment of international transactions, particularly "incoming" transactions, is subject to two different—but parallel—bodies of law, there are opportunities for tax avoidance, as well as pitfalls for the uninitiated.

For example, the Code "effectively connected" concept could be conformed to the "attributable to" concept of tax treaties. The terms and conditions of Code sections 872(b) and 883(a), permitting reciprocal exemptions for profits from the operation of ships and aircraft, could be coordinated with the concepts of the U.S. Model. At least some Code source rules could be modified to conform to treaty source rules. There are undoubtedly other candidates for better coordination, but a degree of cooperative study between Congress and the Treasury will be required to identify and pursue them all.

Question 13. There is evidence that the U.S. Virgin Islands are being used as a tax haven. The tax shelter involved is based on a provision of the Revised Organic Act of the Virgin Islands of 1954, 48 U.S.C. § 1641, which provides that a person whose "permanent residence" is in the Virgin Islands can satisfy his U.S. income tax obligations by paying the U.S. Virgin Islands tax on his worldwide income. But the Virgin Islands tax laws are a "mirror image" of the U.S. Internal Revenue Code, so that if the U.S. Virgin Islands permanent resident is (with respect to the U.S. V.I.) a foreign corporation, it is only taxed on U.S. V.I. source income (i.e., income from the U.S. is taxfree). It is unclear whether this scheme is effective to avoid taxes because there is little law on the question. The IRS seems to be tolerating this treatment for a U.S. corporation with at least 80 percent of its gross income from U.S. V.I. sources. See Rev. Rul. 80-40, I.R.B. 1980-7 (February 19, 1980). What should our policy be here? What administrative and enforcement measures have or should be taken?

Answer. Some persons have suggested that a United States person with permanent residence in the Virgin Islands would escape both United States income tax and Virgin Islands territorial income tax with respect to non-Virgin Islands source income not effectively connected with a Virgin Islands trade or business. Revenue Ruling 80-40 illustrates why we believe this suggestion is incorrect. An inhabitant of the Virgin Islands must pay taxes to the Virgin Islands on its income from all sources in order to be relieved of its tax liability to the United States. If such person fails to file a return or pay tax to the Virgin Islands on its worldwide income, the person does not satisfy its U.S. tax obligations. Concededly, the law on the issue is sparse and unclear. Nonetheless, we believe the ruling is correct; certainly it cannot be described as tolerating tax haven use of the Virgin Islands.

The Administration is in the process of preparing draft legislation entitled the "Territorial Tax Act of 1980" that would resolve the ambiguities, complexities, and potential abuses inherent in the "mirror" systems of taxation utilized in certain U.S. territories by replacing them with the Federal income tax system. Such legslation would reduce, if not eliminate, tax avoidance possibilities. Implicit in most of the tax avoidance schemes is the assumption that the Virgin Islands does not have sophisticated enforcement capabilities. Under the Admnistration's proposal, tax compliance would be improved by Internal Revenue Service administration of the tax laws in the territories. Such legislation is the best policy choice in this area.

Question 14. Professor Hugh Ault commented that the United States should be willing to enter into more limited agreements that concern exchange of information and nondiscrimination only. He questioned the need for a full-blown treaty with all the countries we presently have. What is your position with respect to Professor Ault's suggestion?

Answer. The Treasury Department is willing to enter into limited agreements concerning exchange of information and nondiscrimination (and other subjects, in appropriate cases, as well) in lieu of comprehensive income tax treaties. We question, however, whether many countries—particularly those countries which are the greatest source of concern—would be willing to enter into a treaty on such a limited basis. A limited treaty of this nature would impose burdens on the other jurisdiction without granting relief from U.S. statutory taxation. Moreover, some countries prefer a comprehensive treaty simply because such treaties have gained international recognition and acceptance, whereas limited treaties may be perceived as unusual and therefore more difficult to justify.

Question 15. Given that the U.S. does not, in some circumstances, tax the capital gains of non-resident aliens and that some of our treaty partners do not tax gains on assets located abroad, it is possible that some U.S. source capital gains are not being taxed at all. Do you have any idea of the magnitude of income that might escape taxation totally in this way? Which of our major treaty partners would fall into this catgory?

Answer. Because of the interaction of Internal Revenue Code provisions and the provisions of foreign internal law, some U.S. source capital gains derived by nonresident aliens may not bear any income tax. We do not know the amount of income which falls into this category. As far as we can determine, however, most OECD countries generally tax their residents on gains irrespective of where property is located. In some cases, however, some types of property, or some classes of persons, are not taxed or are taxed at reduced rates. Germany, Japan, Canada, France, and the U.K. tax most types of property on a worldwide basis. The largest category of gain likely to escape taxation is gain on the sale of stock or securities in United States corporations. Our statutory provisions governing such sales reflect a deliberate Congressional decision to encourage foreign portfolio investment in the United States as well as a judgment that collection of tax on sales of such stock abroad would be difficult.

Question 16. It was suggested at the hearing that the Netherlands "pushes" itself as a tax haven by way of its tax treaty network. Do you agree? If not, why not? Does Treasury intend to take any action concerning the Netherlands treaty?

Answer. The Treasury Department is attempting to determine whether the Netherlands activity promotes any potential it may afford for treaty shopping. Officials of the Treasury Department have informally discussed this matter with officials of the Netherlands. If, after further examination, it appears that the Netherlands treaty poses a serious potential for treaty shopping and that that potential is being exploited, the United States will request that the Netherlands renegotiate our treaty relationship.

Question 17. Last fall I met with representatives of your office and the GAO concerning the problem GAO had encountered in reviewing the activities of the competent authority in IRS because of treaty secrecy clauses. I wrote to Treasury in mid-December to urge that you expeditiously resolve the matter as promised and report to me no later than January 31, 1980. Virtually no progress has been evidenced and no response has been received.

(a) When can I expect to receive Treasury's position on whether legislation is needed to allow Congress to monitor treaty administration?

(b) One recommendation received at the hearing was to study the effectiveness of exchange of information provisions. How would you suggest this be accomplished in light of treaty secrecy clauses?

Answer. The Treasury Department has met with both the Internal Revenue Service and GAO on several occasions since meeting with you. As a result of these discussions the Service is reviewing its initial position with respect to its ability to allow GAO to review competent authority documents. The IRS review has been extensive and has required consultation with our treaty partners. When it has been completed we will be in a position to advise you on the possibility under present law of a GAO review of the effectiveness of exchange of information provisions. We have regularly discussed our progress with your staff.

Question 18. In December of 1979 I wrote you about the administration of our present tax treaty with the Netherlands Antilles.

(a) What is the Administration's current views as to whether U.S. corporations that establish finance subsidiaries in the Antilles are eligible for the favorable treaty rules?

(b) If these arrangements do not qualify for the favorable treaty rules why has the IRS failed to enforce this view?

(c) If they do qualify, why did IRS revoke the pre-1974 favorable rulings?

Answer. Whether an Antilles finance subsidiary qualifies for benefits under the treaty between the United States and the Antilles depends on the facts and circumstances. Such subsidiaries raise difficult questions under *Plantation Patterns*, 462 F. 2d 712 (1972), and *Aiken Industries*, 56 T.C. 915 (1971), acq.

1972—2 C.B. 1. No general determination can be made. Rulings published before 1974 relating to the bona fides of the indebtedness and to determining the true debtor were intended to ensure that such obligations in the hands of Americans would be subject to the interest equalization tax. After that tax was reduced to a zero rate on July 1, 1974, and then repealed, the Service stated in Revenue Ruling 74-764 that those rulings could no longer be relied upon.

Mr. GIBBONS. I want to thank the panel.

Our concluding two witnesses are Marshall Langer, who has testified before this committee before and is an attorney from Miami; and Mr. David Tillinghast, who is an attorney from New York. They are going to testify on how to stop tax treaty shopping abuses.

HOW TO STOP TAX TREATY SHOPPING ABUSE

STATEMENT OF MARSHALL J. LANGER, ESQ., OF THE LAW FIRM OF SHUTTS & BOWEN, MIAMI, FLA.

Mr. LANGER. Mr. Chairman, first, with your permission, I would like to try to clarify the by-play that took place earlier between Mr. Rosenbloom and Dr. Spitz concerning Antigua and Cayman.

Mr. GIBBONS. We would like to have you do that.

Mr. LANGER. Antigua has abolished personal income taxes, but has not abolished corporate income tax, which is, I think, at the 40 percent rate that Dr. Spitz mentioned.

The place that David Rosenbloom may have been thinking about, that has no income tax at all today, is Anguilla, which is another one of the countries to which the old United Kingdom treaty has been extended, and it does have no income tax at all.

Mr. GIBBONS. Where is Anguilla?

Mr. LANGER. It used to be a part of St. Christopher, Nevis and Anguilla. It is about 100 miles south of Puerto Rico and the Virgin Islands, in the Caribbean.

Mr. GIBBONS. That is an interesting place. It is tempting.

Mr. LANGER. On the question of Cayman, there was some serious question as to whether the old United Kingdom treaty had been extended to Cayman at the time it was extended to Jamaica.

In response to an inquiry made at that time to Treasury, back in 1968, the Treasury Department issued a press release, No. F-1368, on October 4, 1968, stating that in the event that the treaty did apply to the Cayman Islands, it would no longer apply to the Cayman Islands effective January 1, 1969.

Mr. GIBBONS. All right. Fine.

Mr. LANGER. If I may, I would like to come to the basic question of treaty shopping, and in my prepared testimony——

Mr. GIBBONS. Which will be a part of the record.

Mr. LANGER [continuing]. I have set forth briefly five different types of treaty shopping examples.

The first one might involve a U.S. multinational company which is issuing Eurobonds to foreign investors. In order to issue those Eurobonds, if it is intended to use the money in the United States, it cannot use a domestic international financing subsidiary. It must use a foreign international finance subsidiary which is typically based in the Netherlands Antilles.

Through the intermediary of such a foreign international finance subsidiary, a large U.S. multinational company can borrow from overseas, and its bonds are free of U.S. withholding tax.

The second example might be a Canadian multinational company doing business in the United States, which may try to reduce the normal 15-percent treaty rate of withholding that would be paid by a U.S. company on income paid to Canada. By interposing a Netherlands holding company of the type described earlier by Dr. Spitz, that effective rate of tax can probably be reduced to 5 percent instead of the 15-percent rate.

A third example would involve a U.S. multinational company doing business in a South American country, with which the United States does not have an income tax treaty, and we don't have treaties today with any of the South American countries.

The company doing business in a South American country may choose to do so through one of its European subsidiaries that is located in a country which does have a treaty with the South American country.

Thereby, it can reduce the effective rate of tax in that South American country by paying its dividends and interest up to its European subsidiary, and then onward to the United States. If it did not do that, it would not suffer from double taxation, but from excessive taxation.

A fourth example might be a nonresident alien individual who comes from a nontreaty country that taxes only domestic source income. He may choose to make his investments in U.S. real estate or in stocks through a Netherlands Antilles holding company.

Finally, a foreign businessman carrying on business in the United States may do so through a Netherlands Antilles or British Virgin Islands company, so the interest and dividends paid by that company will not be subject to any U.S. withholding tax because of the provisions contained in the treaty.

Now, in my prepared paper I have gone through the various cases and rulings and some of the letter rulings that discuss how treaty shopping appears to work, particularly as it applies to foreign persons coming into the United States.

One of the conclusions that I reached from going through the rulings and the letter rulings as well as the cases is that practically anyone who wants to do so can get a 15 percent tax rate on dividends. If someone wants to get a 5-percent rate on U.S. dividends under some of these treaties, particularly the Antilles treaty, then he is going to have to fulfill the requirements of Revenue Procedure 79–40, and the various other requirements that were mentioned earlier.

I have also pointed out in my paper that the attacks, or attempted attacks, by the OECD and by the U.S. model against treaty shopping, are of limited value up to this point; and in fact a 1976 report of the Treasury Department to the Congress contains a quotation which I have set forth in my prepared testimony, which for practical purposes condones treaty shopping.

I would like to spend the balance of my time talking about the effective withholding tax rates and what they really are with respect to foreign persons investing in the United States, and also how they got that way.

The withholding tax was first put in in 1936 and at that time the Ways and Means Committee had considered and rejected a proposed 22.5 percent tax rate because they felt that it would be a deterrent to foreign investment in the United States.

Instead, they put in a rate of only 10 percent as the withholding tax rate. At that time, we had only one tax treaty—with France. In 1942 the rate was increased to 30 percent in order to pay for the war effort during World War II.

Although that theoretically was a temporary wartime increase, the rate has remained at the 30-percent level ever since that time.

I have obtained some figures from the Internal Revenue Service and from the Treasury Department which I have included in an appendix to my prepared statement.

Appendix A, contains figures on tax withholding from payments to foreign persons of treaty and nontreaty countries. This is a table prepared annually by the Internal Revenue Service; until this past year these tables have been included in the annual reports of the Commissioner of Internal Revenue. This year's report did not, but I was able to obtain a copy of it, and I have included it in this attachment to my statement. It shows that 90 percent of all foreign investment in the United States comes from treaty countries, and that 90 percent of the income paid to foreign persons either goes to, or through, treaty countries.

For the year 1977, on a total income of $3.2 billion, we collected withholding taxes of $467 million, or an effective rate of 14.4 percent.

The Treasury has furnished me some tables which I have included in appendix B, which deal more specifically with withholding on interest and dividends. They show that also for the same year, 1977, a total of $515 million of interest was paid to foreign taxpayers, on which the withholding was $24 million, or an effective withholding rate of 4.7 percent on interest.

The comparable rates on dividends show over $2 billion of dividends paid at an effective rate of 15.9 percent.

Now, there are a few very interesting things when you look at these tables, particularly the ones with respect to interest.

In the first place, it does not, of course, include such things as bank deposit interest, which are free by virtue of the Internal Revenue Code and not because of any treaty. There is no reporting of any kind when bank deposit interest is paid to foreign persons.

It does not include, apparently, large portions of Eurodollar bond interest that is paid, although some of that is apparently picked up in connected with the Netherlands Antilles.

It shows that $97 million of total interest was paid to the Netherlands Antilles on which we collected the sum of $77,000, or an effective withholding tax rate of 0.1 percent.

On somewhat smaller figures, we had a comparable result with the Netherlands, where the effective rate was also 0.1 percent.

I must point out I am not an economist; I am just playing with some of these figures—I have analyzed some of the figures that deal with Eurodollar bonds issued by U.S. companies, and as best I can determine from various reports that have been filed with the Congress over the years, U.S. companies have been issued Eurodollar bonds to foreign investors at a rate well in excess of $1 billion per year for the last 15 years or so.

I managed to find some recent figures in a publication issued by the Morgan Guaranty Trust Co., of New York, and it shows that for the years 1977, 1978, and 1979, over $5 billion of new bonds were issued by U.S. companies in the Eurodollar market.

This leads me to suggest that the amount listed in the Treasury as total interest paid to the Netherlands Antilles is probably substantially understated. It is my opinion, based upon discussions I have had with some of my colleagues, that conservatively at least 50 percent of these Eurodollar bonds are issued by foreign international financial subsidiaries, through the Netherlands Antilles. If we have at least $10 billion or more of these bonds outstanding, the interest rate would have to be only 1 percent if we were paying $97 million of interest.

So, I am suggesting that the total interest paid through the Antilles is obviously considerably higher than the Treasury figures show.

One thing that ought to be seen from these tables is that our statutory withholding tax rate, that is, the 30-percent withholding tax rate, is largely a myth; it does not exist for any sophisticated taxpayer.

If someone wants to get a reduced rate of tax, it is obvious that he can get it down to below 5 percent on interest and, without a great deal of trouble, he ought to be able to get it down to around 15 percent in the case of dividends.

One of the reasons why we have treaty shopping on the part of people coming into the United States is the very large difference between the rate that we impose under our statute and the rate that can be obtained under the treaties, and which is used by these people through the mechanism of treaty shopping.

I suggest to the committee that if our statutory rate were closer to the real rate that is being paid by these people, we would have considerably less treaty shopping. I have set forth some examples of proposed rates in my prepared testimony.

Mr. Chairman, that concludes my basic comments, and I would be glad to hear any questions you may have after you have heard from Mr. Tillinghast.

[The prepared statement follows:]

STATEMENT OF MARSHALL J. LANGER, ATTORNEY, MIAMI, FLORIDA

My name is Marshall J. Langer, and I am a partner in the Miami law firm of Shutts & Bowen. I specialize in international tax planning, working primarily with foreign clients who invest in the United States. I have worked with tax treaties for more than 20 years, and I teach a graduate law course in tax treaties at the University of Miami. A second edition of my book, "Practical International Tax Planning," was published last year.[1] I am also completing work as coauthor of two volumes on tax treaties which are scheduled to be published this September.[2]

You have asked me to discuss treaty shopping and to suggest ways that treaty shopping and other tax treaty abuses can be controlled. I am pleased to respond to this request.

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[1] "Practical International Tax Planning," 2d Edition (Practising Law Institute, New York, 1979).

[2] Rhoades and Langer, "Income Taxation of Foreign Related Transactions," vols. 3 and 4 (Matthew Bender, New York, 1980).

INTRODUCTION TO TREATY SHOPPING

Treaty shopping involves the use of a bilateral tax treaty by a person resident in a third country. There are numerous instances in which an individual or corporation investing or carrying on business overseas may benefit from successful treaty shopping. Here are just a few:

A U.S. multinational company issues Eurobonds to foreign investors through its Netherlands Antilles international finance subsidiary so it can pay interest on the bonds free of U.S. withholding tax.

A Canadian multinational company doing business in the United States may use a Netherlands holding company to reduce the U.S. withholding tax on its dividends from 15 percent to 5 percent.

A U.S. multinational company doing business in a South American country with which the United States has no tax treaty may do so through one of its European subsidiaries based in a country that does have a tax treaty with the South American country.

A nonresident alien individual from a non-treaty country that taxes only domestic-source income may invest in U.S. real estate or stocks through a Netherlands Antilles holding company.

A foreign businessman carries on his business in the United States through a company formed in the British Virgin Islands (BVI) so that its interest and dividends paid to foreign persons are exempt from U.S. tax.

Typically, the multinational company is not trying to avoid all taxes; it is merely trying to avoid double taxation or higher expenses. It does not want to get stuck with excess foreign tax credits that it cannot use. A United Kingdom company investing abroad doesn't want to pay an overall effective rate of tax exceeding 52 percent on its profits plus dividends from its operations in any country. Similarly, a U.S. company operating abroad wants to avoid overall taxes exceeding the current 46-percent U.S. tax rate. If its foreign taxes are less than 46 percent, it merely pays the difference up to that rate to the IRS; but if its effective foreign taxes on foreign income exceed that rate it gets no U.S. tax benefit for the excess. If its bond interest is subject to withholding tax, it will have to pay a much higher rate of interest.

Individual investors from some countries may be in the same position as a multinational company. Some, however, come from countries with less onerous tax systems that exempt all foreign-source income or permit unlimited deferral through the use of offshore investment companies. Let us examine an example:

Assume that Juan Sanchez, a citizen and resident of Venezuela, buys a portfolio of $1,000,000 worth of U.S. stocks. Venezuela, like some two-thirds of all Latin American countries, taxes its residents only on a territorial basis. It imposes no income tax on foreign-source income. Thus, Sanchez pays no Venezuelan taxes on his dividends or capital gains from U.S. stocks. Venezuela gives Sanchez no foreign tax credit for taxes he pays abroad so he is anxious to pay the least possible amount of total taxes to other countries. Assume that his stocks produce an average dividend yield of 5 percent, or $50,000 per year, and that he averages capital gains of 10 percent, or $100,000 per year.

If he invests directly—using no intervening investment company—he pays 30 percent U.S. withholding taxes on the dividends, or $15,000 per year. His capital gains are tax-free. If he dies, however, the entire portfolio will be subject to U.S. estate tax. If his stocks are then worth $2 million, the U.S. estate tax will be about $380,000. Sanchez can form an investment company in a non-treaty country. His income taxes will remain the same, but he will have eliminated the estate tax problem.

Suppose, however, that his investment company qualifies as a Barbados international business company (hereafter "IBC"). Under the UK overseas treaty as extended to Barbadian companies pay only 15 percent U.S. withholding tax instead of the statutory 30 percent rate.[8] The dividends are also subject to Barbadian tax, but the Barbados tax rate on an IBC is only 2½ percent. The capital gains are also tax-free in Barbados. Thus, by interposing a Barbadian IBC as his investment company, Sanchez not only eliminates his potential United States estate tax problem, but he also reduces his overall tax bill by about $6,000 per year less the cost of maintaining his investment company.

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[8] United Kingdom Overseas Treaty, Art. VI.

The foregoing is an example of treaty shopping. Sanchez is a resident of Venezuela which has no income tax treaty with the United States; he is not a resident of Barbados. Nevertheless, he has made his investment company resident in Barbados for the purpose of using or abusing—the income tax treaty between Barbados and the United States. Substantially the same result could be obtained using a company based in the BVI.

Despite many thousands of transactions involving various types of treaty shopping, there are still no clear guidelines as to what is permissible and what is not. No provision in the Internal Revenue Code directly prohibits treaty shopping. However, some general rules and concepts of tax law have been used from time to time by the IRS to attack treaty shopping.

It is quite clear, for example, that the IRS does not recognize a nominee as the owner of an asset. If Sanchez bought the U.S. stocks personally and registered them in the name of a Swiss bank as nominee for him, the IRS would treat Sanchez as the real owner for both income and estate tax purposes. But if he forms an offshore investment company to own them, the result may be quite different.

CASES ALLEGING SHAM TRANSACTIONS

The IRS has attacked some attempts at treaty shopping on the ground that they were sham. It used that argument successfully to win cases against Inegmar Johansson and Aiken Industries. It lost a similar attack against Perry Bass. Let us look briefly at these cases:

Johansson, a Swede was a world heavyweight boxing champion. Although Sweden had a treaty with the United States, its provisions did not help him. In order to try to take advantage of an exemption provision contained in the Swiss treaty, he claimed that he had become a resident of Switzerland and that he was boxing in the United States as an employee of a Swiss corporation. The court held this was a sham and it taxed him; he also lost the fight.[4]

Aiken Industries, a U.S. corporation, owed more than $2 million to a related Bahamian corporation. Interest payments on the notes were substantial and were subject to 30 percent U.S. tax. To avoid this, the Bahamian corporation transferred the notes to a newly-created Honduran corporation in exchange for nearly identical notes of that corporation. The notes were virtually back-to-back. The Honduran corporation claimed that it was exempt from U.S. tax under the treaty then in force between the United States and Honduras.[5] The Tax Court treated the interposition of the Honduran company under such circumstances as a sham.[6]

Bass, a U.S. person, transferred an undivided working interest in oil producing properties to his wholly-owned Swiss corporation in 1960. It was exempt from U.S. tax on its share of the oil income under the Swiss treaty. The Tax Court held that the Swiss corporation was a viable separate entity and that Bass was not taxable on its income. Everything concerning the maintenance of the Swiss corporation had been properly done and it had acted like a viable corporation.[7]

THE SUEZ CASE

In a case involving the Suez Canal Company, the Court of Claims held that the company was Egyptian, not French, and that it was therefore not entitled to benefits under the French treaty. The court added by way of dictum that since the company was not subject to French taxes it would not be entitled to any benefits under the French treaty even if it had been held to be a French company. It reasoned that the treaty was designed to prevent double taxation and could not be used to prevent any taxation a all.[8]

PUBLISHED RULINGS

A 1975 ruling permitted persons who were not residents of the Netherlands Antilles to form an Antilles corporation to invest in U.S. real estate through a U.S. limited partnership. It recognized the right of the Antilles corporation to certain benefits under the Netherlands Antilles treaty. Although the persons who formed the Antilles corporation could have become limited partners individually, they would then have had to file individual U.S. income tax returns. The IRS recognized that factor as one of the acceptable business reasons for permitting the interposition of the Antilles corporation.[9]

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[4] *Ingemar Johansson* v. *U.S.*, 336 F. 2d 809, 14 AFTR 2d 5605, 64–2 USTC ¶ 9743 (5th Cir. 1964).

[5] The Honduran treaty was terminated in 1966.

[6] Aiken Industries Inc., 56 T.C 925 (1971).

[7] Perry R. Bass, 50 T.C. 595 (1968).

[8] *Compagnie Financiere de Suez et de L'Union Parisienne* v. *U.S.*, 492 F.2d 798, 33 AFTR 2d 74–769, 74–1 USTC ¶ 9254 (Ct. Cl. 1974).

A 1979 ruling dealt with a U.S. subsidiary of a Netherlands Antilles corporation that refused to provide the IRS requested information showing that the relationship between the parent and subsidiary wasn't arranged or maintained primarily to secure the reduced 5-percent treaty rate on intercompany dividends. The IRS ruled that the failure to supply the requested data prevented the 5-percent rate from applying.[10] It appears, however, that the 15-percent rate would apply notwithstanding an apparent tax-avoidance motive.

LETTER RULINGS CONDONE SOME TREATY SHOPPING

Several letter rulings have had fact patterns which involve treaty shopping. One dealt with a Netherlands finance company owned by a so-called "country Y corporation".[11] Three others dealt with Netherlands Antilles corporations that were owned respectively by a resident of Bermuda, a nonresident alien from an undesignated country, and a resident of Honduras.[12] Each of these four letter rulings involved the taxation of dividends to be paid on substantial direct ownership of stock in a U.S. corporation. The treaties in point provide for a 15-percent rate on portfolio dividends and a special reduced rate of 5 percent on qualifying dividends from affiliates. In each case the off-shore corporation was claiming entitlement to the 5 percent rate. In some it got the 5-percent rate; in others it was only allowed the 15-percent rate. Without ever discussing the subject of treaty shopping, each letter ruling gave tacit approval to use of the treaty to reduce the United States withholding tax to 15 percent or less. Each of these letter rulings carefully pointed out that the treaty country corporation was under no obligation to turn over the dividends it received from the U.S. affiliate to its shareholder. This seems to reflect an attempt by the IRS to distinguish the facts in the letter ruling from the Aiken Industries case. Since each treaty country corporation involved was wholly-owned by a person from a non-treaty country, one may question whether this was really a material distinction.

The letter ruling involving the Netherlands finance company made it quite clear that treaty shopping had been a key purpose for establishing the finance company in the Netherlands. It stated:

"The Netherlands was selected for incorporation because it is a financial center that imposes no withholding tax on interest paid by a Dutch entity to foreigners, and because of its favorable internal income tax structure and extensive network of tax treaties providing for favorable treatment of interest income paid to Dutch entities." [13]

The letter ruling involving the Antilles corporation owned 100 percent by a Bermuda resident suggested several "business reasons" for this structure, including the favorable regulatory tax and investment climate in the Netherlands Antilles. It pointed out that nothing would require the Netherlands Antilles corporation to turn over dividends received by it to any other person or entity and that the Netherlands Antilles corporation would exercise dominion and control over the dividends.[14] Although the letter ruling did not discuss treaty shopping, it is obvious that if the Bermuda resident had invested directly in the United States, the rate would have been 30 percent. Thus, we have a clear-cut example of what is in fact treaty shopping approved in a private letter ruling by the IRS.

OTHER TREATY SHOPPING LETTER RULINGS

A number of other letter rulings have involved treaty shopping. Two of the more interesting ones are discussed here:

A Netherlands Antille corporation apparently formed by third country residents owned approximately 49 percent of a U.S. corporation, the other 51 percent of which was owned by Americans. The Antilles corporation lent $400,000 to the U.S. corporation. Since the Antilles corporation owned more than 25 percent, but less than 50 percent of the U.S. corporation, the interest was tax-free in the United States. It apparently also qualified for the special 3 percent Antilles tax rate under an exception to the 1963 protocol. Dividends from the U.S. corporation to the Antilles corporation were subject to 15 percent U.S. tax, but 3 percent or less in the Antilles.[15]

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[9] Rev. Rul. 75–23, 1975–1 C.B. 290.

[10] Rev. Rul. 79–65, 1979–1 C.B. 458.

[11] Letter Ruling 77–23–035.

[12] Letter Rulings 77–39–080, 77–42–048 and 77–42–058.

[13] Letter Ruling 77–23–035.

[14] Letter Ruling 77–39–080. This is somoetimes called an "Aiken representation" since it is made in response to the Aiken Industries case. See n. 4 above.

A Netherlands corporation owned 100 percent of a Netherlands Antilles finance company. It also owned 100 percent of a U.S. holding company which in turn owned U.S. operating subsidiaries. The Antilles finance company lent money to the U.S. operating subsidiaries. Since the Antilles finance company did not "control, directly or indirectly, more than 50 percent of the entire voting power" of the U.S. operating subsidiaries the interest was free of U.S. withholding tax. It would also be subject to 3 percent or less Antilles tax.[16]

OECD MODEL TREATY

The OECD and U.S. model income tax treaties each deal with the question of treaty shopping to a limited degree. Art. 10 of the 1977 OECD model provides that the reduced rate of withholding on dividends to either 15 percent or 5 percent shall apply "* * * if the recipient is the beneficial owner of the dividends * * *." The same language also applies to Arts. 11 (interest) and 12 (royalties). This language had in fact been added in the revised text of these articles which was published by the OECD in 1974. What does it mean? The 1977 OECD commentary indicates that the reduced withholding rate in the source country is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer of the dividend, unless both the intermediary and the beneficial owner of the dividend are resident in the same treaty country.[17] It adds that countries may make this language more explicit during bilateral negotiations.

If this language was incorporated into the Swiss-United States. treaty it would mean that when a dividend was paid from the United States to a Swiss bank acting as nominee for its client, the reduced treaty rate would be available only if the beneficial owner of the dividend was also a resident of Switzerland. In the case if Switzerland that result is already achieved under the treaty withholding regulations.[18] The 1977 OECD model does not make the reduced rate of tax conditional upon the dividends being subject to tax in the country of residence.[19] That question is left to be settled by bilateral negotiations.[20]

The OECD commentary draws attention to a hypothetical case.[21] It doesn't mention specific countries, but I will, so as to make the example clearer. Assume that the beneficial owner of dividends arising in the United States is a Swiss corporation. The capital of the Swiss corporation is held by shareholders who reside outside of Switzerland. It is the practice of the Swiss corporation not to distribute its profits in the form of dividends. The Swiss corporation enjoys preferential tax treatment in Switzerland as a private investment company or base company. Is it justifiable for the United States to allow a reduced rate of tax on dividends paid to such a Swiss holding or domiciliary company? The OECD commentary does not take a position on this question. It merely suggests that it may be appropriate during bilateral treaty negotiations for the parties to agree on special exceptions to the taxing rules laid down in Art. 10 in the case of such corporations.

RECENT U.S. TREATIES

The Treasury has dealt with the foregoing hypothetical case in its U.S. model treaty and in several recent treaties. For example, under the Iceland treaty, if Iceland gives preferential tax rates to an investment or holding company, the company will lose its treaty benefits with respect to dividends, interest, royalties and capital gains unless more than 75 percent of the capital is directly or indirectly owned by individual residents of Iceland or U.S. citizens.[22] The Treasury

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[15] Letter Ruling 77–46–046.
[16] Letter Ruling 77–51–023. See also Letter Rulings 79–31–056 and 80–02–052.
[17] OECD Commentary (1977), Art. 10, ¶ 12.
[18] Reg. § 509.8.
[19] OECD Model Treaty (1977), Art. 10.
[20] OECD Commentary (1977), Art. 10, ¶ 20.
[21] OECD Commentary (1977), Art. 10, ¶ 22.
[22] Iceland Art. 27.

Department's technical explanation of the treaty indicates that the purpose of the provision is to deal with potential abuse that could arise if the combination of low tax rates in Iceland and reduced U.S. tax rates or exemptions would enable third-country residents to realize unintended benefits. Similar language appears in United States treaties with Finland,[33] Norway,[34] Trinidad,[35] and the United Kingdom,[36] and in the 1977 U.S. model treaty.[37] Special treaty provisions deny the use of treaty benefits to Luxembourg holding companies[38] and to some Netherlands Antilles corporations.[39]

The Treasury's treaty program may eventually stop third-country residents from using treaty-country investment or holding companies to obtain unintended treaty benefits. However, it may take many years until the Treasury completes renegotiation of all of the present U.S. treaties. Moreover, there is no assurance that all treaty partners of the United States will agree that treaty shopping constitutes an abuse.

TREASURY DEPARTMENT REPORT

A 1976 Treasury Department report to the Congress on foreign portfolio investment in the United States contains some interesting comments on the use of tax treaties by residents of third countries. It states:

"Treaties providing for reduced withholding rates induce foreign investors of countries without treaties with the United States to form either personal holding companies or trusts in the foreign treaty jurisdiction in order to have their investments in the United States receive favorable withholding tax treatment. These entities are then afforded the benefit of treaty tax rates applicable to the jurisdictions in which they are operating."[40]

WITHHOLDING TAXES

The Internal Revenue Code imposes a 30-percent withholding tax on dividends, interest, royalties and various other types of fixed or determinable annual or periodical income paid to foreign persons, except as reduced by income tax treaties.

When the withholding tax was first introduced in 1936 the statutory rate was 10 percent. The House Ways and Means Committee had rejected a possible 22½-percent rate as a deterrent to foreign investment. At that time we had only one tax treaty—with France. The statutory withholding tax rate was raised to 30 percent during World War II for the stated purpose of generating revenue to pay for the war effort. It has never been reduced by Congress.

EFFECTIVE RATES

Foreign taxpayers have found ways to bring United States withholding tax rates down to an effective overall rate of about 14½ percent, largely through the use of tax treaties. Nearly 90 percent of all income paid to foreign persons goes to treaty countries. IRS figures reflect that total income paid to all foreign persons amounted to about $3.2 billion for the year 1977.[41] The withholding tax collected was about $467 million, making the effective overall rate about 14.4 percent.

At least with respect to the income that went to nontreaty countries, I would have assumed that the withholding tax rate should have amounted to 30 percent of the total income paid. It did not. For some unexplained reason the total tax withheld from payments to foreign persons of nontreaty countries was about $63 million out of a total income of approximately $325 million, making the effective tax rate only about 19.4 percent. As might be expected, the tax rate was even lower for payments to foreign persons in treaty countries. It averaged approximately 13.9 percent for all treaty countries.

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[33] Finland–2, Art. 27.

[34] Norway–2, Art. 20.

[35] Trinidad–2, Art. 16.

[36] United Kingdom–2, Art. 16.

[37] U.S. Model (1977), Art. 16.

[38] Luxembourg Art. 15.

[39] Netherlands Antilles 1963 protocol Art. I.

[40] Report to the Congress on Foreign Portfolio Investment in the United States 42, U.S. Treasury Department, Washington, DC (1976).

[41] See Appendix A for a table prepared by the IRS entitled "Tax Withheld from Payments to Foreign Persons of Treaty and Nontreaty Countries—Calendar Year 1977." Similar tables for the years 1973 through 1976 appear in the Annual Reports of the Commissioner of Internal Revenue for the years 1975–78. The corresponding figures for such years are not significantly different from those for the year 1977.

Over three-fourths (75.9 percent) of all income paid to foreign persons during 1977 went to only six treaty countries, with these results:

On total income of $679 million paid to Switzerland, the effective withholding tax rate was about 21.8 percent, including additional withholding recovered from Switzerland.

For Canada the effective rate was about 13.6 percent on total income of $532 million.

For the United Kingdom, the effective rate was about 10.8 percent on total income of $481 million.

The Netherlands had total income of about $348 million. The effective withholding tax rate was about 11.8 percent.

For France the effective rate was about 10.7 percent on total income of about $258 million.

The Netherlands Antilles had total income of about $160 million on which the effective withholding tax rate was about 6.4 percent.

INTEREST AND DIVIDENDS

The Treasury Department has prepared tables dealing with interest and dividends paid to foreign persons for the same year, 1977.[illegible] These tables reflect the following additional data:

On total interest income of $515 million paid to foreign persons, the effective withholding rate was 4.7 percent.

Nearly one-fifth of that interest, $97 million, was paid to the Netherlands Antilles at an effective withholding rate of 0.1 percent.

On total dividend income of a little over $2 billion paid to foreign persons the overall effective withholding rate was 15.9 percent.

More than 85 percent of those dividends went to eight treaty countries at an effective withholding rate of 14.7 percent.

FIGURES SEEM LOW

Since 1965, U.S. companies have issued long-term Eurobonds at an average rate of over $1 billion per year.[illegible] Some of these have been issued through Delaware-based domestic international finance subsidiaries, but I believe that more than half of them have been issued through foreign international finance subsidiaries based in the Netherlands Antilles.

We can safely assume that at least $5 billion of Eurobonds issued through the Netherlands Antilles are presently outstanding and that the effective interest rate is at least 8 percent. The interest paid to (or through) the Antilles would therefore be at least $400 million per year, over four times the amount shown by the Treasury's figures. The actual discrepancy is probably somewhat higher.

If we could really collect 30 percent withholding tax on all of the interest paid to foreign persons on Eurobonds issued by U.S. companies through the Netherlands Antilles, the tax would be well over $100 million per year instead of the $77,000 which the Treasury figures show we actually collected on such interest during 1977.

Our statutory 30 percent withholding tax rate is a myth for the average foreign taxpayer. It is also extremely unrealistic for many types of income. A 30 percent rate on dividends makes the combined overall tax about 62 percent on all corporate earnings that are paid out to foreign shareholders.

A 30-percent rate on interest reduces the yield on a 10-percent bond to an unacceptable 7 percent. This makes the 10 percent domestic bond completely unsalable to foreign persons. Instead, the foreign portfolio investor invests in U.S. bank deposits which pay interest tax-free and in Eurobonds which also pay interest tax-free. A 30-percent rate on gross royalties is probably the equivalent of a 60-percent tax on net royalties when costs are taken into account. A 30-per-

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[illegible] See Appendix B for three tables prepared by the Treasury Department's Office of Tax Analysis for the year 1977.

[illegible] See Treasury and Commerce Department reports to Congress under the Foreign Investment Study Act of 1974. See also World Financial Markets, published monthly by Morgan Guaranty Trust Company of New York.

cent rate on gross rents often equals more than 100 percent tax on net rents. Here, at least, Congress has given some relief in the form of an election to be taxed on a net basis.[34]

SUGGESTED REFORM

In view of the fact that almost all foreign investments in the United States come through treaty countries, it no longer makes sense to have a wide discrepancy between the nontreaty withholding tax rate and the prevailing treaty rate for a given type of income. I therefore suggest that consideration be given to nontreaty withholding tax rates approximately 5 percent over the prevailing effective rates. I suggest:

A 20-percent withholding tax rate on portfolio dividends.

A 10-percent rate on direct dividends.

A rate of not more than 10 percent on interest, or complete elimination of withholding on interest paid to foreign persons.

A rate of not more than 15 percent on royalties.

A rate of not more than 15 percent on gross rents.

Flexible rates like those suggested above might help to cut down on treaty shopping.

Alternatively, we could have a more realistic flat nontreaty withholding tax rate of 15 percent on all types of income.

We should consider using a refund system like that used in Switzerland under which the statutory withholding rate is collected from all foreign persons regardless of treaties with refunds given only to those persons who establish that they are entitled to treaty benefits.

SOME OTHER TAX TREATY PROBLEMS

Approximately 90 percent of all foreign investment in the United States now comes from (or through) countries with which we have income tax treaties. Taxation often depends on an overlay of both treaty rules and those in the Internal Revenue Code. The treaty rules generally follow modern international concepts developed by the OECD, while many of our Code rules were developed over 60 years ago and are archaic. The Code and U.S. tax treaties are "badly out of sync."[35] The Code rules in this area should be studied and revised.

I have tried to confine my statement to treaty shopping and treaty abuses. These hearings are also focusing on other problems involving tax treaties. I have added brief comments on a few of these in an appendix to this statement.[36]

CONCLUSION

The United States has not always taken a consistent position about the use of its tax treaties by unintended beneficiaries. Until effective action is taken to stop treaty shopping, taxpayers from third countries will continue to use tax treaties to their advantage.

Mr. Chairman, I would be pleased to answer any questions the Committee may have.

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[34] IRC §§ 871(d) and 882(d).

[35] Statement made by H. David Rosenbloom, International Tax Counsel of the Treasury Department, March 1979.

[36] See Appendix C.

APPENDIX A

TAX WITHHELD FROM PAYMENTS TO FOREIGN PERSONS OF TREATY AND NONTREATY COUNTRIES, CALENDAR YEAR 1977

[Amounts in thousands of dollars]

Country	Total income	Total tax withheld	Tax withheld by domestic withholding agents	Tax from foreign governments or withholding agents	Number of information documents filed by withholding agents
Total	2, 238, 527	466, 967	391, 200	75, 767	590, 815
Treaty countries, total	2, 913, 867	403, 977	328, 210	75, 767	494, 506
Australia [1]	10, 396	1, 878	1, 878		7, 329
Austria	5, 735	654	639	15	5, 314
Belgium	82, 432	12, 818	10, 022	2, 796	14, 531
Former Belgium o/s territories [2]	55	7	7		134
Canada	532, 481	72, 473	66, 132	[3] 6, 341	261, 034
Denmark	4, 401	338	331	7	2, 113
Finland	857	26	6		374
France [1]	257, 611	27, 639	27, 317	322	14, 544
Federal Republic of Germany	115, 412	11, 112	11, 112		49, 902
Greece	3, 549	574	574		3, 266
Iceland	129	16	16		27
Ireland	10, 955	700	663	37	3, 861
Italy	24, 740	3, 658	3, 658		9, 455
Japan	135, 393	12, 100	12, 100		4, 393
Luxembourg	18, 842	3, 970	3, 679	291	5, 414
Netherlands	347, 836	40, 991	40, 414	577	12, 057
Netherlands Antilles	160, 095	10, 319	10, 314	5	1, 288
New Zealand [1]	1, 536	208	208		1, 720
Norway	4, 391	529	529		3, 591
Pakistan	485	37	37		285
Poland	700	96	96		316
Romania	69	10	10		75
South Africa	2, 831	721	721		2, 010
Sweden	25, 657	2, 350	2, 350		4, 577
Switzerland	679, 282	148, 181	83, 802	64, 279	27, 716
Trinidad and Tobago	207	33	33		324
U.S.S.R	1, 093	45	45		470
United Kingdom [1]	480, 593	51, 668	50, 671	997	57, 293
Former United Kingdom o/s territories [2]	6, 104	826	826		1, 093
Nontreaty countries	324, 660	62, 990	62, 990		96, 309

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[1] Includes dependencies covered by tax treaties and former territories which have become independent countries.

[2] Includes former territories which have become independent countries.

[3] Only total amount of tax withheld is available; breakdown between tax withheld by domestic withholding agents and tax from foreign governments or withholding agents is estimated from past experience.

APPENDIX B

TABLE 1.—INTEREST AND TAX WITHHELD ON INTEREST PAID TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS BY PAYEE'S COUNTRY OF RESIDENCE, 1977

[Money amounts in thousands of dollars]

Country	Total interest	Total withheld on interest	Effective withholding rate
Antigua	2,970	0	0
Australia	674	192	28.5
Bermuda	1,809	473	26.1
Belgium	9,820	1,220	12.4
Canada	129,461	9,195	7.1
France	30,150	2,785	9.2
West Germany	6,515	107	1.6
Hong Kong	1,814	313	17.3
Ireland	309	21	6.8
Italy	3,894	352	9.0
Japan	36,237	2,073	5.7
Luxembourg	4,232	129	3.1
Mexico	2,261	617	27.3
Netherlands	29,691	26	.1
Netherland Antilles	97,026	77	.1
Panama	2,618	465	17.8
Puerto Rico	281	75	26.7
Switzerland	61,908	2,820	4.6
United Kingdom	28,359	283	1.0
United States	1,825	14	.8
Venezuela	2,356	112	4.8
Subtotal	454,290	21,349	4.7
All other countries	61,128	3,083	5.0
Total	515,418	24,432	4.7

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 2.—DIVIDENDS AND TAX WITHHELD ON DIVIDENDS PAID TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS BY PAYEE'S COUNTRY OF RESIDENCE, 1977

[Money amounts in thousands of dollars]

Code—Country	Total dividends	Total withheld on dividends	Effective withholding rate
AR—Argentina	1,429	421.5	29.5
AS—Australia	4,021	594.2	14.8
AU—Austria	3,732	558.2	15.0
BD—Bermuda	11,765	3,317.7	28.2
BE—Belgium	54,789	8,066.7	14.7
BF—Bahamas	13,827	3,682.0	26.6
CA—Canada	295,605	55,985.8	18.9
CJ—Cayman Islands	3,103	872.3	28.1
DA—Denmark	1,841	242.3	13.2
FR—France	169,790	21,035.5	12.4
GC—East Germany	16,293	2,460 0	15.1
GE—West Germany	60,515	9,039.6	14.9
GR—Greece	2,239	521.2	23.3
HK—Hong Kong	10,841	3,520.4	32.5
EI—Ireland	9,632	556.5	5.8
IS—Israel	1,732	462.0	26.7
IT—Italy	11,627	1,886.4	16.2
JA—Japan	50,935	6,050.8	11.9
LI—Liberia	1,052	307.5	29.2
LS—Liechtenstein	5,360	1,570.8	29.3
LU—Luxembourg	14,180	3,456.3	24.4
MX—Mexico	4,548	1,271.9	28.0
NL—Netherlands	246,132	36,849.2	15.0
NA—Netherland Antilles	54,046	10,129.9	18.7
NE—Nive	140	22.6	16.1
NO—Norway	2,911	430.9	14.8
PA—Panama	6,650	1,884.5	28.3
SF—South Africa	1,291	337.1	26.1
SP—Spain	3,016	881.9	29.2
SW—Sweden	18,730	1,882.4	10.1
SZ—Switzerland	534,116	76,439.4	14.3
UK—United Kingdom	308,266	44,382.7	14.4
US—United States	1,716	297.9	17.4
VE—Venezuela	3,586	1,039.9	29.0
VI—British Virgin Islands	1,633	248.6	15.2
Subtotal	1,931,089	300,706.6	15.6
All other countries	95,748	21,248.0	22.2
Total	2,026,837	321,945.6	15.9

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 3.—INTEREST AND DIVIDENDS PAID TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS BY PAYEE'S COUNTRY OF RESIDENCE, 1977

	Amount (thousands)	Percent of total	Effective withholding rate
Interest:			
Canada	$129,461	25.1	7.1
Netherlands Antilles	97,026	18.8	.1
Switzerland	61,908	12.0	4.6
Japan	36,237	7.0	5.7
Subtotal	294,632	57.2	7.6
All other countries	229,786	42.8	7.6
Total interest	515,418	100.0	4.7
Dividends:			
Switzerland	534,116	26.4	14.3
United Kingdom	308,266	15.2	14.4
Canada	295,605	14.6	18.9
Netherlands	246,132	12.1	15.0
France	169,790	8.4	12.4
West Germany	60,515	3.0	14.9
Belgium	54,789	2.7	14.7
Netherlands Antilles	54,046	2.7	18.7
Subtotal	1,732,259	85.1	14.7
All other countries	303,578	14.9	21.2
Total dividends	2,026,837	100.0	15.9

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

APPENDIX C

SOME OTHER PROBLEMS CONCERNING TAX TREATIES

1. *Hearings on U.S. Model Treaties.*—The current U.S. model tax treaties are good, but they can be improved. They should be the subject of intensive hearings before the Congress. The Treasury should be asked to explain in detail the reasons why its models differ from those recommended by the OECD and the extent to which it proposes to follow the OECD commentaries.

2. *Effect of New OECD Commentaries.*—There are many areas in which the 1977 U.S. model income tax treaty closely follows the 1977 OECD model. What concerns me is the extent to which the OECD commentaries are binding on the U.S. Treasury, the Internal Revenue Service, and our courts in the interpretation of U.S. tax treaty provisions that closely follow those is the OECD model.

Many existing U.S. income tax treaties follow the old 1963 draft OECD model. With respect to many provisions there has been little or no change in the model treaty language itself, but there has been a substantial change or complete revision of the applicable commentaries. Which commentaries do we apply in interpreting such a provision—the old one, the new one, or neither?

The OECD Committee on Fiscal Affairs recommends that the new commentaries should apply as far as possible under such circumstances.[1] It suggests that treaty partners adopt the new commentaries by means of an exchange of letters between their competent authorities.

When the Senate ratified these existing tax treaties, it knew or should have known about the OECD commentaries as they existed at that time. It could have had no way of knowing about new commentaries to be issued at a later date.

The idea of generating retroactive legislative history for our tax treaties is quite disturbing. I urge the Treasury and the Congress to review this situation.

3. *Outdated Treaty Regulations.*—The last set of treaty regulations was issued by the Treasury Department more than ten years ago (in 1969) under the French treaty. Treasury officials have indicated that treaty regulations are no longer necessary because the Treasury has expanded the technical explanations that it presents to the Senate Foreign Relations Committee on each new treaty. How-

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[1] Model Double Taxation Convention on Income and on Capital—Report of the OECD Committee on Fiscal Affairs 1977, ¶ 30 at 15. *See also U.S. v. A. L. Burbank & Co. Ltd.*, 525 F. 2d 9, 36 AFTR 2d 75–6227, 75–2 USTC ¶ 9795 (2d Cir. 1975), cert. denied, 426 U.S. 934 (1976), in which the court relied in part on OECD commentaries drafted long after the applicable treaty provision to support its holding.

ever, these expanded technical explanations were already being issued 15 years ago when the Treasury was considering the issuance of master treaty regulations. The master treaty regulations were intended to be in addition to and not instead of the expanded technical explanations.

In a 1964 speech, Professor Stanley Surrey (then Assistant Secretary of the Treasury) indicated that the Treasury was exploring the desirability of issuing a single master income tax treaty regulation covering all U.S. income tax treaties.[3] He suggested that appendices could show the points at which any of the treaties contained provisions at variance with the master framework. Among other things, this would permit a clear awareness of the precise places at which any one particular treaty varies substantially from the standard form.

Unfortunately, the idea was never acted upon. We still don't have master treaty regulations. We no longer get any new treaty regulations. Moreover, the existing treaty regulations are badly out of date and sometimes relate to treaties that are no longer in effect.

Technical explanations are not a satisfactory substitute for treaty regulations. They are issued without public hearings and comment and they are not capable of being amended to reflect later changes in law.

Mr. GIBBONS. Mr. Tillinghast?

STATEMENT OF DAVID TILLINGHAST, ESQ., OF THE LAW FIRM OF HUGHES, HUBBARD & REED, NEW YORK, N.Y.

Mr. TILLINGHAST. Thank you, Mr. Chairman. I feel somewhat apprehensive about coming to bat so late in the ninth inning, but I will try to be brief.

Mr. GIBBONS. You go right ahead. I have the time.

Mr. TILLINGHAST. I think the basic question which the idea of the treaty shopping raises is the basis for determining whether all treaty shopping is abusive or whether there are kinds of resort to treaties which we might call treaty shopping which are justified. My own view is that under present circumstances there are some of each.

In order to decide when one might be justified in shopping for a treaty—I might say, parenthetically, I focus my attention in my prepared statement and these remarks mainly on persons from abroad investing in the United States—one needs to look at the rules which apply to such persons under the Internal Revenue Code and the difference in those rules which are affected by the treaty provisions, and ask, why the difference?

In a simple-minded way, one might think: If the rule in the statute is a good rule, why do we vary it by treaty, or if the rule in the statute is not a good rule and the rule in the treaty makes sense, why not change the statutory rule?

Mr. Rosenbloom has quite properly pointed out that there are some situations where tailoring to individual country needs is required. I agree with that. It requires the negotiation of treaties; it is an important function of treaties. I submit, however, that in this particular area that the subcommittee is inquiring into, many of the things that the treaties are doing are not necessitated by tailoring to specific country problems.

In many treaties, in particular cases the rate of withholding tax on dividends going to foreign parents of U.S. subsidiaries is reduced to 5 percent. There is nothing peculiar about the particular countries for which that rule is provided. That rule could be provided in the Internal Revenue Code. You might want safeguards and we will come back to that. The question of exemption from withholding tax of interest payments is the subject of pending legislation, and I agree with what Mr. Rosenbloom said about that. The system is a piece of swiss cheese at the moment.

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[3] Speech to Tax Executives Institute, Montreal, Canada, Sept. 21, 1964.

I think there are reasons for exempting interest. I think there are reasons for doing it in treaty, but I am not sure those reasons are peculiar to the particular countries involved, and, therefore, I think the decision on whether to exempt interest or to tax it at 30 percent, or another rate, is basically a tax policy decision.

Let me take one other quick example, and then I will go on. Mr. Rosenbloom, or other witnesses, referred to the fact that most treaties provide that the United States may not tax the income of a foreign business unless that business is engaged in trade or business here through a permanent establishment, whereas the statutory rule in the United States is that the tax may be imposed if the enterprise is engaged in trade or business, without the permanent establishment requirement.

To my mind, there is nothing about that rule which needs to be tailored to the particular circumstances of the country. It is a question of what is an appropriate threshold of the U.S. tax jurisdiction.

My personal view is that the treaty rule is a better rule for a variety of reasons, but that is not as important as the fact that there is a discrepancy there, and that leads me to my point, which is that a lot of companies and a lot of individuals who resort to the benefit of treaties to invest in the United States are not—in some sense that we might agree on—bad guys; they are resorting to well-known rules which are well accepted through the community of the developed nations, but which the United States happens to recognize only through treaty.

I think we could agree on a number of cases, which I won't go into here, in which we would say that a genuine business, genuinely availing itself of a rule which is to its benefit, is not an evasionary or even in a pejorative sense an avoidance case.

It is impossible for me to go through all of those. It is impossible for me even to suggest the considerations that would relate to all the treaty rules that might fall into this category; but let me just refer to two, because I think they have some importance in trying to make these decisions:

A frequent reason why individual investors resort to a treaty is because they can—as Mr. Langer indicated—reduce the withholding tax which is paid on dividends they receive at least to 15 percent, which is the usual rule in a treaty, as against the 30 percent which is provided in the statute.

My own view is that I don't see any reason why the United States should provide that facility to a foreign investor unless it is willing to provide a 15-percent rate for everyone.

Now, there is one reason why the United States might reduce its withholding rate, and that is as a bargain with the other treaty country over the sharing of revenue from that dividend income. If the treaty partner comes to the United States and says, "If you impose withholding tax at 30 percent, you in effect will be getting all the tax out of this income, or you will be imposing a tax at rates in excess of the rates payable by the investor in his home state." That is a bargain between the countries over the sharing of revenue or the proper basis of overall tax on that revenue.

However, if that country does not itself impose an income tax, it seems to me hard to see why we should depart from our generally applicable statutory rate. An argument could be made that 30 percent is rather a high rate, but that is a question of what the general applicable statutory rate is.

To take a difficult situation, I want to take the case of two multinational companies that engage in a joint venture; this is a usual phenomenon which is, in fact, becoming more prevalent in the current economic situation where basically the two companies pool their businesses, worldwide.

Now, normally, as you know, they operate through multicorporate forms. There will be many operating entities and it is necessary to move money through by intercorporate dividends from one company to another. Normally, it is necessary for those companies to try to find a place in which their holdings of subsidiaries can be pooled, which will not impose high withholding taxes; the reason is, I think, that within the corporate enterprise we look at the tax burden differently from the way we look at it for the individual investor.

In our system, a corporate tax is one thing, and in addition there is a tax on dividends received by the individual investor. That is an entirely different thing.

Within the corporate system, we tend to regard taxes on intercorporate distributions as being on top of the existing tax load. We look at the corporate enterprise as basically one entity, even though there are several pieces of it. My prepared statement refers to some of the provisions in the code that do that.

If you look at the corporate enterprise as an overall taxpayer suffering an overall tax burden, you start with the business in the United States, which pays its 46 percent corporate tax rate here; you then pile on top of that a 30 percent withholding tax on dividends that are paid out of the United States to some entity which is probably a holding company in a neutral corner—it may not be a tax haven—and then frequently the enterprise is faced with the fact that another withholding tax is payable when those earnings pass from that holding company to the ultimate parent or parents.

You can get a number which goes up—in one case at least that I am familiar with—as high as an 80 percent overall effective rate on those earnings before they get to the home country, just because the withholding taxes are proliferate.

Companies in that situation often resort to treaties because there are treaties—the Netherlands is one case that has been referred to here this morning; I might say I am not rising in defense of the Netherlands but I would like to describe how it works in one case—where, if you were doing a pooling of this kind, the very kind of things that Mr. Spitz referred to, would be resorted to.

There would be a 5-percent withholding tax coming out of the U.S. subsidiary to the Netherlands holding company. There might be a 5 or 7 or even zero withholding tax on the dividend from the Netherlands back to a parent company located in Germany or in France.

But our attitude as to whether that is an impermissible type of tax avoidance seems to be quite different, simply because we have acknowledged in our treaty policy that we are willing to live with the 5 percent dividend withholding rate in this kind of direct investment situation; and I think we do that for the reasons that I referred to before, concerning our view of the overall tax burden.

In any event, I would regard this as being a case which we could agree on, where to resort to treaties, as against the 30 percent withholding rate, was justified; and I think there are probably other cases where it is not.

That makes the question of stopping treaty abuse somewhat harder, I do admit, but I don't think it is an impossible problem.

I think Mr. Spitz referred before to the provisions of the Luxembourg treaty, where the reduction of withholding rates is denied to a Luxembourg holding company because the United States is not satisfied with the way that company is taxed in Luxembourg; in effect it can be used as an impermissible conduit to other investors, and I think that similar provisions can be drafted.

I think the main purpose of my remarks is simply to suggest that there are two kinds of cases and that they need examination in light of the effects of the treaty and, more importantly, whether the rules which are currently embodied in the Internal Revenue Code are ruling—the ones which are internationally supported—and, when viewed for fairness and equity, are sustainable.

One final comment of importance.

One of the features of many U.S. treaties is to remove what we call the secondary withholding tax, which is a withholding tax imposed on dividends and interest paid by foreign companies which derive the bulk of their income from business in the United States.

Much of the controversy about treaty shopping and tax havens has come about by the fact that in many of our treaties—or several of them, I should say—we waive the secondary withholding tax and do not impose withholding tax on a dividend or interest payment made, let us say, by a Netherlands Antilles company, even though that company's income is entirely derived from business in the United States.

I think that is a mistake. I think it is something that we fell into, sort of by the accident of history. I think that this is the prime case where in general terms whatever is the right rule may be specified in the Internal Revenue Code and where there need be few variations of that rule by treaty.

I suspect that the only case in which basic variation of the rule is justified is a case in which the foreign country itself imposes a withholding tax on the interest and dividend payments and, for negotiating or other reasons, the United States feels that it is willing to forgo the revenue involved and to allow the withholding tax to be imposed by the foreign government, even though under our domestic rule we would impose it.

But where the foreign country imposes no withholding tax on the dividend or interest payment, it seems to me that when the Internal Revenue Code rule says that the income should be considered U.S. source, and therefore subject to withholding tax, there is no reason for giving it up.

The rate of the tax is a separate matter and was covered by prior remarks.

[The prepared statement follows:]

STATEMENT OF DAVID R. TILLINGHAST

Mr. Chairman, my name is Davil Tillinghast. I am a member of the law firm of Hughes Hubbard & Reed in New York and Adjunct Professor of Law at New York University. At one time I held the position in the Treasury Department which is now known as International Tax Counsel. The views I express here are, of course, personal to me.

The subject of "treaty shopping", as it has come to be called, is an important one; and like many important policy issues it tends to be discussed in simplistic and even polemic terms rather than receiving the dispassionate analysis which it deserves. This hearing is thus most welcome.

To put the matter simply, foreign companies and investors often seek to qualify for the benefits of tax treaties negotiated by the United States with countries other than their own. They may do this because their home country has no tax treaty with the United States or because the treaty of another country is more favorable in some relevant way than the treaty their home country has negotiated. In a few cases (involving major sums) the treaty of critical interest is not a treaty with the United States but a favorable treaty between the home country and a third country through which the investment in the United States will be made.

I would like first to describe some of the principal situations in which "treaty shopping" arises and then consider the question of actual or potential abuse.

REASONS FOR TREATY SHOPPING

There are any number of good non-tax reasons why a company or an investor might form a holding or investment company in a third country which has a tax treaty with the United States. Nevertheless, there is no doubt that in most cases an important or even decisive motivation is to reduce taxes—or to minimize the risk of taxation. Before jumping to conclusions, however, we must decide whether this is necessarily and always a bad thing. The very reason there are tax treaties in the world is that the simultaneous application to the same income of two (or more) national tax systems, each of them framed with domestic policies principally in view, may produce harsh and unintended results. One cannot condemn the utilization of a treaty for the purpose of avoiding or reducing a tax (or the risk of a tax) until one finds out what the effect of that tax is. And, upon examining into the matter, one finds that often it is not a U.S. tax which is at issue in any event.

Avoidance of double taxation

Let me take the simplest case first. Suppose that a company wants to do business in the United States. It understands that, according to universally recognized international practice, the United States will tax the income of that business. It finds, however, that under the law of its home country, there will be no foreign tax credit or similar allowance for the U.S. tax; the company will be subject to double taxation if it invests directly.

This company will now "shop", if that is the appropriate verb, for a country in which it can form a subsidiary where there is a recognition of the United States tax and a provision to avoid the double taxation. It will also seek a country where that protection is likely to continue into the future. While this might be a country which has no tax treaty with the United States but makes an appropriate allowance under its domestic law, it is more likely to be a country which has a treaty. In the first place, many countries which would be selected on other grounds do have treaties with the United States; and the company may consider a double taxation provision to which the other country is bound by treaty to be more likely to remain in force than a provision of internal law. (While tax treaties normally are terminable on relatively short notice, such an action obviously has much more severe international repercussions than a mere change of domestic law.)

A variation on this theme may involve tax avoidance, but not avoidance of United States tax. Again the company wishing to do business in the United

States concedes that its business will be subject to U.S. tax. If it invests directly, it will be allowed a credit for the U.S. tax under the law of its home country; but the rate of tax in the home country is higher and the amount in excess of the U.S. rate will be an added burden. The company instead incorporates a subsidiary in a third country which has a treaty with the United States providing that double taxation will be avoided by that country's exempting income from its tax when that income is taxed by the United States. (The treaties between the United States and France and West Germany, for example, provide for this.) In such a case, no U.S. tax is avoided; rather it is the foreign tax which is reduced.

Protection of the "permanent establishment" rule

A second frequent reason for resort to the benefits of a treaty is the so-called "permanent establishment" rule. Under the Internal Revenue Code, a foreign company or person can be subjected to the full rates of U.S. tax if found to be "engaged in trade or business within the United States". This is an amorphous concept, illuminated (with minor exceptions) only by judicial decision and then not with great clarity. It appears, however, that relatively little contact with the United States is required. The Internal Revenue Service has taken the view, for example, that a company may be engaged in business in the United States when it sells its product here through independent distributors, even though the company itself does nothing in the United States. (Rev. Rul. 55–617, 1955–2 Cum. Bull. 774; cf. Frank Handfield, 23 T.C. 633 (1955)). This not only raises the prospect of a tax for which very little benefit is received but may also produce double taxation. Most important, it creates major uncertainties. The prudent practitioner therefore often advises a client that may have marginal U.S. contacts to seek the protection of a treaty.

Under all of the U.S. tax treaties, as well as those concluded by other countries, a foreign person benefitting from the treaty can be taxed by the United States on business income only if that person has a "permanent establishment" in the United States. This is a technical term, but it has two important characteristics: first, it is defined in the treaty, so the business knows (more nearly, at least) where it stands; and second, it raises the threshold of contact with the United States which is necessary before the U.S. may impose tax. For example, the foreign company selling its product through unrelated distributors, though engaged in business in the United States, was held by the Internal Revenue Service not to have a permanent establishment in the United States and therefore not to be subject to tax under the Belgian Treaty. (Rev. Rul. 55–27, supra; cf. Rev. Rul. 76–322, 1976–2 Cum. Bull. 487.) This is a garden-variety reason for resorting to a treaty, which is put into practice every day.

The "annual net election" for real estate income

The third motivation for obtaining the benefits of a treaty relates to the taxation of gains on the sale of real estate. The members of the Subcommittee will recall the Report submitted by the Treasury Department in May of last year on the taxation of foreign persons with respect to income and gains on United States real estate, as well as the bills on this subject which are now before the Congress (H.R. 1212; H.R. 1319; H.R. 2297). I do not propose to go into this matter here, since I believe that the subject is already a familiar one.

Reduction or elimination of U.S. withholding taxes

The fourth motivation for resorting to a tax treaty is to take advantage of provisions which reduce or eliminate the withholding taxes imposed by the United States on investment income, principally royalties, interest and dividends. In my judgment, this area presents the most difficulty because many very different types of transactions fall under the same heading.

Portfolio Investment.—Again to take the simplest case first, let us consider an individual investor whose country has no tax treaty with the United States. If well advised, the investor will usually, although not always, make his U.S. portfolio investments through a holding company organized outside the United States. (By doing so, the possibility of incurring a U.S. estate tax is avoided.) This company could, of course, be created in the investor's home country. If so, dividends and interest received from the United States would normally be subject to the 30 percent withholding tax provided for in the Internal Revenue Code. If, instead, the company is created in a country which has a tax treaty with the United States, the tax on dividends can be reduced to 15 percent and the tax on interest eliminated in many cases. (Generally, the United States does not impose tax on capital gains, with or without a treaty, except those effectively connected to a U.S. business or, if pending legislation is enacted, those derived from U.S. real estate.)

So far, the use of the treaty has saved the investor money because the U.S. withholding taxes have been minimized. This will be the end of the matter if the holding company reinvests the income. If, however, it seeks to distribute the income to the investor, consideration must be given to whether the country in which the holding company is located imposes its own withholding tax; if it does, then—depending on the rate of course—the savings in U.S. withholding tax may be eaten up by the second withholding tax. From the investor's point of view, the ideal place to locate a holding company is a country where (a) a treaty with the United States results in a reduction of U.S. withholding taxes and (b) no local withholding tax is imposed. (It is also important that the country impose no estate tax by reason of the investor's ownership of shares in the holding company.) The popularity of some of the well-advertised "tax haven" jurisdictions has depended essentially on these factors.

Corporate Direct Investment.—Similar motivations may influence foreign corporations investing in subsidiary or joint venture companies in the United States. In this case, however, the perspective in which the problem must be viewed is quite different. The basic structure of the United States tax system is a "classic" one, in which taxes paid by a corporation are one thing and taxes paid by an individual shareholder are a separate matter. While the "double taxation" of corporate earnings—once in the form of a corporate income tax and again when received as dividends by shareholders—has been decried by some, the United States has not adopted the "integration" approach employed by several other countries.

In such a system, tax burdens on individual investors are quite properly viewed by ignoring the tax paid at the corporate level. By contrast, where one corporation owns a substantial interest in another, the United States system generally, though sometimes myopically, regards the two as an integrated entity for tax purposes and avoids imposing repetitive taxes at the corporate level when earnings are distributed from one corporation to another. Thus, corporations within an 80 percent-owned group can file consolidated returns and pay only a single corporate tax. In other cases the inter-corporate dividend deduction embodied in section 243 of the Code assures that at least 85 percent of an inter-corporate dividend will be free of the second corporate tax. In the international area, section 902 of the Code permits a U.S. corporation receiving a dividend from a foreign corporation to claim credit for foreign taxes imposed on the foreign corporation (as long as there is a 10 percent voting stock ownership). This accurately mirrors the way in which business enterprises view their tax burdens—as an over-all effective rate, regardless of the number of corporate entities involved.

Under these circumstances, withholding taxes imposed on dividends flowing internationally from one entity in an integrated corporate group to another are appropriately thought of as an addition to the over-all tax burden. So viewed, any substantial withholding taxes can quickly escalate the tax burden beyond reasonable limits.

If, for example, the U.S. subsidiary of a foreign parent company pays the 46 percent U.S. tax rate on its earnings and then distributes them subject to the statutory withholding tax of 30 percent, this will raise the tax burden on the earnings to 62.2 percent. If, as is frequently the case, the recipient of this distribution is itself a subsidiary of another parent corporation located elsewhere, yet a second withholding tax could become payable; if this were imposed at, say, 25 percent it would raise the over-all tax burden to almost 72 percent.

Such situations are not at all fanciful. In fact, in the present economic circumstances, these problems are particularly acute because of the proliferation of joint ventures between companies located in different countries. Because such cases usually involve both operating entities and parent companies located in several countries, problems of proliferation of withholding taxes on intercorporate distributions are particularly severe. I have myself seen at least one case where, absent tax treaty protection, the over-all corporate tax rate on distributed earnings would have risen as high as 80 percent.

Obviously this is an intolerable situation, and it is generally recognized as such. Therefore, countries, including the United States, often include in tax treaties a provision reducing the withholding tax rate on dividends in direct investment situations to 5 percent. Such a provision is included in the Model Tax Convention prepared by the Fiscal Committee of the Organization for Economic Cooperation and Development. In some treaties (though none to which the United States is a party) a total exemption from dividend withholding taxes is provided. Thus, where corporate direct investment and joint ventures are concerned, the resort to treaties is to reduce taxes, but in many cases to what may fairly be regarded as reasonable, rather than "tax haven", levels.

Interest Payments.—A somewhat different problem is raised by withholding taxes imposed on interest payments. In general, payments do not involve the same problems of pyramiding taxes as dividends, since under United States practice the payor of interest on bona fide debt is entitled to a deduction even if the payee is a related party. The problem here, however, is that the withholding tax is based on the gross amount of interest payable. Where the lender is receiving a return on its own funds, this may be acceptable. Where, however, the lender is a financial institution (and to some extent in other cases), imposition of a substantial tax on a gross basis may be essentially confiscatory. The reason is, of course, that the institution is a financial intermediary; it has itself borrowed the lion's share of the funds which it lends. While it is impossible to identify any particular borrowing with any particular loan, money being fungible, over-all the cost of funds must be recovered. If a bank's average borrowing costs equal 70 percent of the interest it receives on amounts it loans, a 30 percent withholding tax on the gross interest it receives is obviously tantamount to a 100 percent tax on its profit, even ignoring operating costs.

The cost picture of each lender may differ, of course, and there is no readily adaptable technique for taking this into account in a withholding tax system. Nevertheless, problems of this kind are severe enough that it has become common in tax treaties to exempt interest paid from withholding tax. This also has an incidental advantage in keeping American borrowers competitive. Several countries exempt interest paid to foreign persons from their withholding taxes, regardless of treaty provisions. Therefore, in international bond markets investors demand to receive interest free of withholding tax; if one is imposed, the borrower normally must pay it on top of the market interest rates. As a result, many international borrowings are in one manner or another routed through a country which has an appropriate treaty with the United States.

Royalties.—The third major area where withholding taxes may come into play involves royalties. Here again, the imposition of withholding tax on a gross basis may, by reason of expenses incurred in earning the royalty, produce a very high rate of tax on net income. Once more tax treaties frequently take this into account by exempting royalties from withholding tax or at least reducing the rate of tax to perhaps 5 or 10 percent; and licensors will seek to have royalties become payable to companies located in treaty countries.

The secondary withholding tax.—Before leaving the subject of withholding taxes, I should add a few words concerning the so-called "secondary" withholding tax imposed by the United States. If a foreign person receives interest or dividends from a U.S. corporation, this income is generally U.S.-source income, and therefore subject to the U.S. withholding tax. If the interest or dividend is paid by a foreign corporation, the income is generally not considered U.S.-source income. If, however, the foreign corporation derives 50 percent or more of its gross income from the conduct of business in the United States a pro rata portion of that income is U.S. sourced. The foreign corporation is therefore required to withhold U.S. tax when it pays dividends or interest to its non-U.S. lenders or shareholders. This is often referred to as the "secondary" U.S. withholding tax.

This rule is considered inappropriate by many other countries. Their view is that a dividend or interest payment has its source in the country where the paying company is organized, regardless of where the company earned the income. To accommodate this view, many U.S. treaties provide that the U.S. will not impose this "secondary" withholding tax on interest and dividends paid by companies organized in the treaty country. In some cases, the United States has agreed to this even though th eforeign country involved in fact imposes no withholding tax of its own. An enterprise which expects to do business or otherwise receive a majority of its income from taxable United States sources will often, therefore, incorporate a company in a tax treaty country, rather than in the United States; in such a case the company can take advantage of the treaty to pay interest or dividends free of U.S. withholding tax, even though an identically situated U.S. corporation would be required to withhold tax at the appropriate statutory (or treaty) rate. In an oversimplified way, this explains one otherwise rather curious practice—the formation by both U.S. and foreign companies of Netherlands Antilles finance subsidiaries to borrow funds in international markets for the capital needs of the corporate group.

THE IMPLICATIONS OF TREATY SHOPPING

From the foregoing, it is apparent that "treaty shopping" arises in a number of quite different circumstances. They all involve reduction of taxes or tax risks (although not always United States taxes or tax risks). They differ, however, in how justifiable this objective is in policy terms. The starting point for any inquiry into the use or misuse of income tax treaties is the reasonableness and equity of the statutory rules which taxpayers are trying to avoid and why there are treaty rules which are more favorable. In other words, if the statutory law is inequitable, why not change it for all taxpayers, rather than changing it only in some cases by treaty? On the other hand, if the statutory rule is sound, why change it by treaty at all?

There are, it seems to me, two kinds of answers to these questions. The first are procedural or tactical. It appears that in some cases, at least, either the Congress or the Executive has preferred to maintain what might be called a "tough" rule in the statute, knowing that it can be relaxed by treaty, if it turns out that a safety valve is needed. Sensible rules of international taxation are sometimes difficult to explain to a relatively unknowledgeable constituency, and it is true that the tax treaty route is generally a low-profile way to deal with politically difficult questions.

Moreover, it is a temptation for the Treasury Department to maintain "tough" statutory rules as an inventory of bargaining chips in the sometimes arduous treaty negotiating process. When a country like Canada, for example, adopts relatively high statutory withholding rates on dividends and interest paid to foreigners with the express avowal that these are to be negotiated down in bilateral tax treaties, it is tempting to do the same. While this is not the subject of this statement, I think that there are, however, other ways to deal with those tactical problems.

The second set of answers to the questions posed above are substantive, and I think that they principally turn on two issues. The first is a simple and practical question of maximizing revenues. The Congress might decide, for example, that in principle a withholding tax should be imposed on royalties paid to foreign persons and yet not disapprove a treaty waiving that tax where the effect of a reciprocal waiver by the other country of its withholding tax would produce revenue effects balancing out in the United States' favor. My only observation on this is that such revenue effects depend on a complicated set of factors, including principally foreign tax credit effects, and may prove a shifting sand on which to build a national policy.

The second question is this: Does the appropriate U.S. rule depend upon whether tax is paid, or enough tax is paid, to another country by the affected taxpayer? If the answer to this question is no, then I see no reason why there should be any need for a treaty rule different from the statutory rule. (I recognize that particular treaty rules may be required to adapt general policies to particular foreign tax systems; but in the broad, I believe this is accurate.) If, however, the answer is yes, then the treaty process may be necessary because what is proper for a taxpayer paying tax in a foreign country is not proper for one paying little or no tax and the foreign country's system must be examined in each case. Let me illustrate this by reference to some of the situations I discussed above.

Double taxation.—If a foreign taxpayer must resort to a treaty to avoid a duplicative second tax on income taxed by the United States, I see no reason for us to object. On the contrary, we have a real interest in permitting this, to avoid discouraging the free flow of capital to the United States. The investor's action plays upon the tax provisions of foreign countries, but I see no reason why we should attempt to shape or counteract their policies. The whole question simply resides beyond the horizon of United States policy concerns.

Permanent establishment.—For my part, I see little virtue in requiring enterprises to resort to tax treaties in order to qualify for the protection of the "permanent establishment" rule. In the great bulk of the cases with which I am familiar, the stricter "engaged in business" rule of the Internal Revenue Code is unduly harsh.

This does not seem to me to be an issue which depends upon whether the taxpayer is taxed abroad. It is a question of defining when a business earning income has had enough contact with the United States to justify the imposition of a United States tax. If the business enters the United States in an economically meaningful way, it will be subject to U.S. tax under either the "engaged in business" rule or the "permanent establishment" rule. In other cases, if the business finds it possible to earn a profit by carrying on business in a jurisdiction which imposes no income tax, I do not believe that foregoing the imposition of U.S. tax can be regarded as encouraging tax evasion.

The net basis election for real estate.—As I have indicated above, the subject of the use of treaties to avoid taxation of gains on sale of U.S. real estate is already the subject of legislation pending in the Congress. Without commenting on the substance of that legislation, I would say only that I see no reason for fundamentally different statutory and treaty rules in this area. The only serious issue is whether gain on the sale of real estate should be taxable. This may or may not be good economic policy. As a matter of tax law, however, the general international consensus confirms the prior taxing right of the country where the property is located; and in general I think that the United States can properly expect other countries to deal with any double taxation problems which arise. It may be, however, that treaties will continue to play a subsidiary role in the real estate area if the pending legislation is enacted, since subsidiary overlaps with foreign tax systems may require resolution.

Withholding taxes.—As indicated above, the imposition of withholding taxes poses the most difficult set of questions. Without answering them all, perhaps I may offer at least some relevant observations.

To begin with, I believe that a forceful case can be made for exempting interest paid to foreign persons from the statutory withholding tax or, if this is not acceptable, imposing withholding tax only at a rate far lower than the existing 30 percent. There is little question that this is an unrealistic rate to apply to interest earned by banks and other financial intermediaries, for the reasons described above. Other developed countries, supported by widespread practice in which the United States has long concerred, are willing reciprocally to exempt interest payments from withholding tax by treaty. The chief effect in practice of maintaining a high statutory withholding rate while following the accepted treaty policy is to force foreign investors into financial intermediation (or creation of treaty country finance companies), rather than permitting them the choice of lending directly. Moreover, given the rules of the game in international markets, it is realistic to think of any withholding tax as being borne, explicitly or implicitly, by the U.S. borrower where it is not avoided through treaty rules. While this is of course a policy issue for the Congress, I doubt that in these cases the revenue to the government justifies the increase in costs and loss of flexibility to U.S. borrowers.

It may be that there should be some limitations on the types of borrowings which are exempted. Borrowings of U.S. subsidiaries from related companies are one area of concern, since to a substantial extent related party bororwings may be substitutes for equity investment, with ramifications too extensive to summarize here. Nevertheless, I believe that United States policy should be realistic, recognizing that efforts to trace borrowings to their ultimate source are likely to be futile in the international context and that attempts to do so, through reporting requirements and the like, may so distort the operation of normal markets as to throw the baby out with the dirty bath water. H.R. 2297, now pending in the Senate, although not corresponding to these recommendations in every respect, would exempt interest from withholding taxes in a broad range of cases.

As far as withholding taxes on dividends are concerned, I would like once again to strike the distinction between portfolio and direct investments but to reverse the order of the discussion.

As a general proposition, it would seem appropriate to impose a very low rate of withholding tax—such as the 5 percent often found in tax treaties—in all cases of inter-corporate direct investment. The same considerations which justify establishing such a rate in a treaty justify establishing it as part of the statutory law of the United States. If we are willing, as we are, to prescribe a low rate by treaty, even where the dividend received by the foreign parent company is exempt from tax in its home country, there is no reason to refer to the tax or amount of tax imposed abroad; and the rule can be established by statute. This is a case, I believe, where the common treaty rule is the right one because, in the direct investment context, adding a 30 percent withholding tax to the underlying corporate tax rate simply raises the corporate tax burden too high.

Some care will be required, of course, to define the direct investments to which the rule is appropriate. It should not be extended, for example, to an investment in a U.S. subsidiary which is itself a portfolio investor, since the combination of the inter-corporate dividend deduction and the low withholding rate might have an inappropriate effect. There is, however, a model already in being which can be adopted or adapted to take account of this case. Thus, some of our existing tax treaties contain a provision limiting the 5 percent withholding rate to dividends received by a company from a U.S. corporation in which it owns at least 25 percent of the stock and which derives the bulk of its income from operations or from subsidiaries which are operating companies.

It can be said that such a rule may still leave a loophole, because an individual investor, wishing to acquire at least 25 percent of the stock of a U.S. operating company, may make the acquisition through a "tax haven" holding company to qualify for a lower rate of withholding tax than he would bear if he received dividends directly. This is a real problem, but it is difficult to see how it may be solved without vitiating the correct treatment in the genuine corporate case. The lower rate should be limited to dividends received by a company whose own dividend distributions are subject to a substantial withholding tax; but, if so, exception would again have to be made for the genuine inter-corporate dividend at the second-tier, and this might only drive the investor into a two- or even three-tier holding company structure. This may be one case where the futility of attempting to trace international money flows should be accepted, and the possible advantage to the individual direct investor accepted as the price of workable rules for genuine corporate investors. No doubt, further study might illuminate ways to minimize this risk; but I wish to emphasize the importance of avoiding dividend withholding rules which unreasonably escalate the tax burdens on corporate investment in the United States.

Dividends on portfolio stock investments in the Unietd States are quite another thing. As I noted above, our system regards taxes imposed upon individual investors as a matter wholly separate from taxes paid at the corporate level. Therefore, the imposition of some substantial withholding tax on dividends paid to a foreign person, to mirror the taxes imposed on domestic shareholders on dividends they receive, seems wholly justified. I am inclined to think that the 30 percent rate is rather high, but not seriously out of line with rates imposed in other developed countries, where one encounters rates as high as 25 percent.

In these cases, reduction of the statutory rate by tax treaty may be a reasonable thing to do for either of two reasons. First, if individual tax rates in the foreign country concerned are relatively low, the U.S. withholding tax may exceed the amount for which the foreign investor can claim a tax credit. Only the investor's home country, of course, can sort out what his net income realy is, taking into account all expenses, personal status, and the like; and the withholding tax at source is really nothing more than a rough approximation of what—on the average—the right level of tax might be. If this guess proves too high in light of tax burdens in a particular foreign country, it may be quite rational for the United States to agree to a reduction, to prevent a disincentive to U.S. investment.

Even where the U.S. withholding tax does not exceed generally prevailing levels of tax in the foreign country, that country may seek a reduction simply because it feels that the United States should not reap the entire tax yield from the dividend income. This then becomes a question of revenue sharing between the two countries, in which such considerations as the revenue to be derived by the United States from a reciprocal concession by the other country will play a legitimate and important part.

In either case, of course, the treaty concession should be made only where the foreign country in fact imposes its regular tax; this requires provisions like the one in the existing treaty with Luxembourg, denying the benefit of a withholding rate reduction to an investment company granted special tax concessions as a means of attracting third-country investors.

The practice of agreeing by treaty to forego the "secondary" withholding tax on dividends and interest paid by foreign corporations whose principal source of income is a business carried on in the United States is one which requires careful examination. To take the extreme case, if a corporation organized in a nearby foreign country derives all of its income from a business conducted in the United States, the economic reality is that it is little different from a United States corporation conducting the same business. This suggests that, in a substantial number of cases at least, the United States is justified in refusing to give up its "secondary" withholding tax.

It is true, I believe, that the statutory rules on this subject can be criticized for being rather aggressive and asymmetrical. Under the Code, a pro rata portion of a foreign corporation's dividend is considered to be from United States sources and thus subject to withholding tax if as little as 50 percent of the foreign corporation's gross income is effectively connected with its United States business. In the converse case, however, dividends and interest paid by a United States corporation are considered entirely to be United States source income, unless the corporation derives less than 20 perecnt of its gross income from sources within the United States. We thus make a claim on the dividend and interest payments of foreign corporations which is broader than the reciprocal concession we are willing to make on the dividends and interest paid by United States corporations which have substantial non-United States businesses. An argument can be made that either dividend and interest payments ought to be considered United States source income on a pro rata basis in the case of both foreign and United States corporations or that an "all or nothing" approach should be taken with respect to foreign corporations, as well as United States corporations.

It is not necessary, of course, that the rules for interest be the same as the rules for dividends. It may be feasible to separate specific interest payments between those which relate to a business in the United States and those which do not, while a similar division of dividend payments would have no basis.

In this connection, it is interesting to note the rules which have been adopted in the tax treaty with France. Dividends paid by a French corporation are considered to be United States source income only if the French corporation has a permanent establishment in the United States and more than 80 percent of the corporation's gross income is taxable to such permanent establishment. (The statute would then make this U.S. source only pro rata.) Interest, on the other hand, is deemed to have its source in the United States if the French company has a permanent establishment in the United States by which the interest was paid and borne; otherwise, no portion of the interest payment is so deemed.

Assuming appropriate statutory rules for the "secondary" withholding tax, the variation of these rules by treaty should prove to be the exception rather than the rule. It is doubtful that the United States should waive its tax where the other foreign country involved does not impose its own withholding tax. This results in an exemption from tax in situations where the United States has a strong economic claim to impose one. On the other hand, in cases where the foreign country involved will itself impose withholding tax on the interest or dividend payments in question, the treaty issue becomes one of revenue allocation between the two countries. In such a case, if the foreign country feels strongly enough that it has a superior right to impose the withholding tax, it is doubtful that the United Sates revenue or policy consideraions involved are strong enough to require a different solution.

Mr. Gibbons. Let me ask you, what is so unique about the Netherlands Antilles?

Mr. Tillinghast. I am tempted to say that Marshall knows more about this than I do, but I will give you a simple answer:

I think there are three things about it, Mr. Chairman, which make it an attractive place:

The first thing is, obviously, that under the appropriate circumstances it imposes a very low rate of tax on a holding company.

The second is that it imposes no estate tax on an individual holding shares in an Antilles company, so if he should happen to die while holding the shares, he does not suffer that. If he held U.S. shares, they would be includable in his taxable estate.

The third is that it does not impose any withholding taxes on outgoing interest and dividends from an Antilles company; and in the treaty we have waived the secondary dividend tax that I referred to.

So, if you had a Netherlands Antilles company which, for example, derived all its income from engaging in business in the United States, or holding real estate, it would pay the U.S. corporate tax; but at that point the investor would be through.

Marshall may want to embroider that somewhat.

Mr. **Langer.** I would add just one thing, and that is, in the real estate field the articles of the Antilles treaty say income of whatever nature derived from either country—from real estate—shall be taxable only in the source country. The Antilles interprets that literally to mean that if there is income from U.S. real estate, the only country that has the right to tax that income is the United States. While they get tax returns from the companies that are formed in the Antilles, that own real estate in the United States, they make no effort to collect any tax on that income.

Despite that, however, some of the treaty benefits like the elimination of the second tax on dividends still apply under the treaty; what you have then is a zero tax haven for these limited purposes that gets some treaty benefits.

Mr. **Gibbons.** What benefit does the Netherlands Antilles get for all this arrangement?

Mr. **Langer.** A lot of company business for lawyers, notaries, accountants and the like. They have an estimated 10,000 companies now.

Mr. **Gibbons.** Really, they are just sort of a clearing-house for this type of operation.

Mr. **Tillinghast.** That is exactly right. They are in the business of being in a place to locate a holding company. It has, along with other places in the Caribbean, certain advantages of a nontax nature for those, particularly, who come from Europe who feel very sensitive about having a place they can lodge investments in the western hemisphere, in a western hemisphere country, which results from uneasiness about political or social conditions in Europe. So it does have that added attraction.

But in terms of what they do down there, it is primarly banking, accounting, and lawyering.

Mr. **Gibbons.** Are you two members of the panel generally satisfied with our tax treaties as they stand today?

Mr. **Langer.** I would have to say no for a variety of reasons. One is that we still have a number of very old treaties that are not regularly looked at. I think that one thing that should be done is that Congress ought to mandate that somebody, whether it is the Congress itself or the Treasury Department, take a good, hard look at our treaties at least once every 5 years to see that they are accomplishing the purposes that were originally intended.

It is my understanding, for example, that the United Kingdom Government does an annual review of all of its treaties to see whether they are doing what they are supposed to.

The best example I can give is that about 15 years ago Barbados passed an International Business Companies Act which imposed a 2.5 percent tax on certain types of investment and holding companies.

It was clearly designed as a means to get low rate dividends out of England and the United States and perhaps other places.

The Brish reacted immediately and within 1 year after the enactment of that act, they put an antiabuse provision into their treaty by virtue of a protocol or amendment to the treaty which said that any company formed under the International Business Companies Act in Barbados would no longer qualify for double tax relief under the treaty.

Now, 15 years have gone by, and we still have a treaty with Barbados, and we have never reacted to that particular law. So, in theory, at least, it is still possible for a Barbadian international business company with a 2.5 percent tax to get a 15 percent withholding tax rate in the United States.

I used that as an example in my prepared statement today. But there are other things as well. We have a model treaty now—and I think it is a big step forward just having it—but the model has really never been the subject of any serious consideration by any of the tax writing committees, nor for that matter, by the Foreign Relations Committee. There may be some things in that model that ought to be studied and reviewed. We ought to decide whether the model is the correct one for now and for the future. And it ought to be a living, growing thing that we can deal with as changes are made over a period of time.

Mr. TILLINGHAST. Let me comment just briefly, Mr. Chairman. I do not disagree with anything, really, that Marshall said. But, perhaps because at one time I sat in the chair Dave Rosenbloom now sits in, I think the Treasury ought to be given credit to balance some of those criticisms, which I think are valid, for having in the last few years come on stronger in terms of having an effective negotiation and renegotiation program.

It is a very difficult process to try to keep in hand as many treaties and potential treaties as the United States has. There are 28, I believe, income tax treaties and as many as a dozen negotiations going on at a given time, not to mention the fact that we do have estate tax treaties which are of some importance to the people they affect.

It is a major program which requires a major effort. My own feeling is that the United States brought to the tax treaty world and to the international tax world in general a great deal more sophistication about these problems than they had before the whole attack—if I can call it that—on tax haven entities surfaced, and that has to be credited primarily to the efforts of the United States.

And while not all the countries of the world obviously agree with this, there are countries which agree enough with the methods and the proposals that the United States has come forward with, not only in the treaty area, but in the statutory area, so that, while the program is by no means perfect, I do think there have been substantial accomplishments.

Mr. GIBBONS. I believe you two gentleman heard Dr. Spitz describe what goes on in the Netherlands. Do you agree with his description or disagree? Then I have a followup question.

Mr. TILLINGHAST. As I recall what Dr. Spitz said, I agree with it as far as its factual nature goes, as to what can be done there. I remember once that a Canadian person, who I think ought to remain anonymous, said: "The economists in our revenue department up here are wonderful. You go and ask them where Canadians invest abroad, and they say that 45 percent of all investment by Canadians is in the Netherlands."

There is obviously a reason for that, and I think the reason is what Dr. Spitz was talking about.

Mr. Gibbons. Do you think this policy is good for the United States? Should we tolerate it?

Mr. Langer. I think one of the things that has happened is we are forced to tolerate some degree of this practice because our statutory withholding rates are out of line. If they were not out of line, and if we brought them down to a realistic level, then we would not have to tolerate those and still be competitive with the rest of the world.

It is incredible to say that you can have a 30 percent withholding tax rates and try to enforce it. The realities are that we do not enforce it and we have not really enforced it except against a handfull of people, and the pitiful amount of revenues that have been collected show that. What has happened is that over a period of time people have come up with methods to cure something that the Congress could have cured in other ways by bringing down the withholding tax rate to a realistic rate and saying, "Now, everybody is going to have to live with it."

Mr. Gibbons. As I recall, your conclusion was that the Treasury's figures were woefully inadequate as far as the Netherlands Antilles is concerned.

Mr. Langer. And probably on the overall interest altogether. I suspect that part of that is because figures are not necessarily reported in all cases. They are obviously taking their figures from the 1099 forms and other data that they get from taxpayers. I suspect that the intercompany interest is often paid by companies that consider it to be effectively connected with the conduct of their trade or business in the United States, and therefore taxable on a net basis, without the necessity of filing a form 1099.

There is a gap in knowing what these figures really are, and perhaps the very first place to start with all of this would be to get much more accurate information as to bank deposit interest and savings and loan interest paid to foreign persons, and Eurodollar bond interest, whether it goes through any of these mechanisms or otherwise, so that we can know what we are really talking about.

Mr. Gibbons. I hate to break this up, but we promised our landlord we would be out of here 5 minutes ago. We had better live up to that part of our agreement.

I want to thank all the members who participated today, the panels, the witnesses, for their very informative and very excellent statements.

And we particularly want to thank Dr. Spitz for coming here and submitting himself to this unique form of American torture. [Laughter]

With that observation, the meeting is adjourned.

[Thereupon, at 1:06 p.m., the hearing was adjourned.]

[The following was submitted for the record:]

Cole, Corette & Bradfield,
Washington, D.C., May 12, 1980.

Hon. **Sam Gibbons,**
Chairman, Oversight Subcommittee, House Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

Dear Mr. Chairman: Enclosed is a memorandum that I recently prepared and send to H. David Rosenbloom, International Tax Counsel, Department of Treasury.

In the memorandum, I present some comments on the existing tax treaty process and make some suggestions for changes in that process.

In the interest of furthering the public debate fostered by the Oversight Subcommittee's recent hearing on income tax treaties, I ask that this letter and memorandum be included in the record of that hearing.

Very truly yours,

Charles M. Bruce,
Attorney, Cole, Corette & Bradfield.

May 14, 1980.

Mr. H. **David Rosenbloom,**
International Tax Counsel, U.S. Department of Treasury, Main Treasury Building, Washington, D.C.

Dear Mr. Rosenbloom: As we are both aware, there is a growing feeling among persons concerned with the treaty process that it may need to be modified somewhat. I recall that not too many years ago the Treasury Department and the Internal Revenue Service reorganized their own approach to the handling of treaty negotiations. The time may come when the relationships between Treasury and the Congress, as they relate to treaty negotiation and ratification, in effect may be similarly reorganized.

The attached memorandum is intended to express my own thoughts on the subject, as one who has given the matter a great deal of consideration over the past couple of years. I am speaking only for myself, however. These views are not necessarily the views of my law firm or any group with which I am presently or have been in the past associated.

I am submitting a copy of this memorandum to the Oversight Subcommittee of the House Ways and Means Committee for inclusion in the record of the recent hearing on income tax treaties.

Sincerely,

Charles M. Bruce.

MEMORANDUM ON SUGGESTED CHANGES IN THE TREATY PROCESS

New generation treaties

I begin with the point that the new generation of bilateral income tax treaties is more substantive than older tax treaties. In the past, tax treaties generally only lowered rates and made changes affecting foreign persons. The new treaties generally do more.

Internal Revenue Code provisions are occasionally overriden. Obviously, this practice is common since one of the functions of treaties is to alter the tax results that otherwise would obtain under internal law.

Patterns are established that can be used as precedents when a particular issue is subsequently raised in the context of the Internal Revenue Code.

The tax treatment of items which may be unclear under existing statutory law can be decided, rightly or wrongly, in the treaties.

Changes that have been considered but not yet adopted by the Congress can be adopted in the treaties.

Some persons would add that on a few occasions the new treaties actually impose or attempt to impose new tax burdens. I will not defend or argue against that point here. Certainly, advantageous rules are created in the treaties which, in a competitive setting, adversely affect the well-being of some taxpayers.

None of this is to say that any of these developments are "bad," but only to point out that the new treaties are perhaps wider in scope than the older treaties.

United States-United Kingdom income tax treaty

The point that the new income tax treaties are substantive and therefore important is evidenced by the hulabaloo over the recent U.S.-U.K. Treaty and Protocols. Members of Congress received as much mail concerning that treaty as they did about a number of important domestic tax issues. That fact is why I believe that the U.S.-U.K. Treaty marks the turning point of Congressional interest in tax treaties. Congress simply is not inclined, in my opinion, to permit the present situation—where important, substantive decisions are made in the context of tax treaties, but those decisions are made at a distance from Congressional processes—to continue.

At the same time, Congress and the general public have become aware that tax treaties play a vital role with respect to several key issues, including foreign investment in the U.S.

Problems with the treaty process

At present, as you are well aware, bilateral tax treaties are negotiated by the Treasury Department with the assistance of the Internal Revenue Service and the State Department and sent to the Senate for approval of ratification. A number of problems, it has been observed, exist with respect to the present state of the negotiation and ratification process.

The process works too slowly and is not sufficiently flexible. I believe that it is generally conceded that the Treasury Department has been too slow in concluding treaties and the Congress has been too slow in processing treaties. I believe that the U.S. should have a widespread, modern, flexible network of treaties and should be able to react to changes in international business and tax practices, and execute new treaties and protocols, with dispatch.

No reconciliation of tax treaty rules with existing Internal Revenue Code rules is ever given to Congress or requested by it. I do not believe it is overstating the fact to say that two bodies of international law are being written; and each one is being written separate and apart from the other. For example, Congress is largely unaware of the rules for taxing offshore exploration, service, and transportation activities being pursued by the treaty negotiators.

Congress has never reviewed the model income and estate and gift tax treaties. One of the witnesses at the recent hearings before the Oversight Subcommittee of the Ways and Means Committee pointed this out.

The House of Representatives has no say in the treaty process. While the Ways and Means Committee and the House can vote on Internal Revenue Code provisions affecting "deferral" and foreign tax credits and the other significant international tax questions, they are powerless to affect provisions in treaties. House Members' only recourse is to legislation overriding treaties (which would severely undercut the treaty process) or legislative gimmickry of some sort (such as, limitations placed in Treasury Department appropriations bills).

The Ways and Means Committee and the Senate Finance Committee, the two tax-writing committees of Congress, are never given the opportunity to bring their considerable expertise to bear on the tax subjects in the treaties. Moreover, they do not receive the benefit of the education that would be gained by concentrating on treaty provisions. For example, I believe that these committees could better legislate on topics such as foreign trusts and information and return filing requirements if they were more closely acquainted with the provisions of the treaties.

Neither the Senate Foreign Relations Committee nor the tax-writing committees receive any prior notification of provisions in the treaties. To my knowledge, prior notification was only given on one occasion—to the Chairman of the Senate Foreign Relations Committee, Senator Sparkman—in recent history.

Revenue estimates are neither given nor requested with respect to most of the treaties' provisions.

While the Staff of the Joint Committee on Taxation follows the treaties and lends technical assistance to the Senate Foreign Relations Committee to the extent requested, the level of its involvement may vary over time.

Not enough attention, in my opinion, is given in tax treaties to questions of pensions and deferred compensation.

I am aware that I am not alone in my concern over these problems. Several Members of Congress, including Members of the Senate Foreign Relations Committee, the Senate Finance Committee, and the House Ways and Means Committee, have expressed their concerns. You will recall that Senator Gravel proposed some changes in the present process during mark-up of the Revenue Act of 1978 before the Senate Finance Committee.

I should note at this point that a very positive development in recent months has been your decision to hold open briefings on a number of significant treaties. Also, the Treasury Department has always solicited comments on treaties.

Some suggested changes

Given this state of affairs and these problems, I would like to suggest that the Treasury Department and the other interested parties—the two Houses of Congress, the various committees of Congress, and the general public—consider the following new proposals. These proposals are frankly intended to give a little relief to each of the concerned groups in such a way as to benefit the process as a whole. They are not designed to help any one group over another. Hopefully, they would result in a better, faster, more flexible treaty network. There should be no constitutional impediments to these proposals given their voluntary nature.

1. *Congressional jurisdiction over tax treaties should remain solely within the Senate Foreign Relations Committee.*—This is necessary because tax treaties involve many sensitive "international relations" questions as well as "tax" questions.

2. *Prior and continuing consultation between Treasury and Congress.*—At the invitation of the Treasury Department, the Speaker of the House, on the recommendation of the Chairman of the Ways and Means Committee should appoint a Majority and Minority Member of that committee and the President of the Senate should appoint, on the recommendation of the Chairmen of the Foreign Relations and the Finance Committees, a Majority and a Minority Member of both of those committees to act as Congressional Representatives in tax treaty negotiations. These representatives might occasionally be invited to sit in on treaty negotiations or informal meetings in connection therewith; in any event, they would be points of contact to be briefed on significant treaty developments. Similar action has been taken with regard to this country's involvement in the United Nations Conference on the Law of the Sea.

3. *Joint resolution to be passed approving model income and estate tax treaties.*—Hearings should be held in the House and the Senate on the Treasury Department's model income and estate and gift tax treaties. The concept of totalization agreements might also be examined. A joint resolution then should be sent to the House Ways and Means Committee on the House side and the Foreign Relations Committee and the Finance Committee on the Senate side and considered by both the House and the Senate.

4. *Tax agreements to be sent to the tax-writing committees.*—When treaties that deviate substantially from the Congressionally-approved model treaties are submitted to the Senate, the deviating provisions should be put in tax agreements. The tax agreements would be introduced by the Chairman of the Ways and Means Committee, on request of the Administration, and sent to the tax-writing committees. There would be no legislative requirement that the Administration propose tax agreements. There would only be the understanding that such agreements might facilitate the treaty process. The agreements could be placed on a fast track (similar to the recent Trade Agreements Act of 1979). The treaties themselves, which would still be sent only to the Senate Foreign Relations Committee, could be made not in order to be placed on the calendar until consideration of the tax agreements is completed.

5. *Permanent JCT Staff position to be created.*—The Staff of the Joint Committee on Taxation should always have an International Tax Counsel responsible for monitoring tax treaty negotiations.

6. *ITC Staff to include an international employment benefits expert.*—A staff person responsible for pension, deferred compensation, and other forms of employment benefits should be added to the staff of the International Tax Counsel under the Assistant Secretary (Tax Policy).

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